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2005



A Status Report
of the
Auditor General of Canada
to the House of Commons

FEBRUARY

Office of the Auditor General of Canada

2005



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The February 2005 Report of the Auditor General of Canada comprises eight chapters and a Message from the Auditor General.



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Auditor General of Canada
Vérificatrice générale du Canada

To the Honourable Speaker of the House of Commons:

I have the honour to transmit herewith my first Report of 2005 to the House of Commons, which is to be tabled in the House in accordance with the provisions of subsection 7(5) of the *Auditor General Act*.

Sheila Fraser

Sheila Fraser, FCA
Auditor General of Canada

OTTAWA, 15 February 2005

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A Message from the Auditor General of Canada



Sheila Fraser, FCA
Auditor General of Canada

A Message from the Auditor General of Canada

I am pleased to present my third Status Report to the House of Commons.

One of Parliament's most important roles is to hold the federal government to account for its use of taxpayer dollars. To fulfill its role as watchdog over the public purse, Parliament needs objective, accurate information on how well the government is managing public funds.

The Office of the Auditor General is an independent, reliable source of such information. Since 1977, my Office has conducted performance audits that examine whether the government is managing its programs with due regard to economy, efficiency, and environmental impact and has measures in place to determine their effectiveness.

The information we provide to parliamentarians gives them a better basis for scrutinizing government operations and evaluating the progress of large-scale initiatives to improve governance. Our audits cover a wide range of topics and provide recommendations with the potential to promote positive, lasting change in the way the government functions.

After our audit reports are tabled in the House of Commons, my colleagues and I frequently appear before parliamentary committees—along with representatives of the departments we have audited—to discuss what we have reported. The Standing Committee on Public Accounts often asks departments and agencies to provide action plans for addressing our recommendations, and it holds them to those plans; occasionally, other standing committees do this as well.

In my view, this Status Report demonstrates that the government does act in response to our recommendations and, in fact, does change for the better. In four of the chapters that follow, we conclude that progress has been satisfactory. We describe the positive steps taken by the Canadian International Development Agency, Transport Canada, and the Canadian Nuclear Safety Commission to resolve issues we raised in previous audits. We also conclude that the government's efforts to modernize its management of human resources are on track.

Unfortunately, we cannot say that the other four areas we audited show satisfactory progress. Much work is still needed on several large-scale initiatives to improve government. Canadians need to see more progress in such critical areas as the governance of Crown corporations, the security of the government's information technology, the accountability of foundations, and the management of the government's financial information.

What has made the difference between the satisfactory and the unsatisfactory progress we report here? We found that it has been the scale and complexity of the change that must be managed and the level of co-operation needed across the government to achieve results. Apart from the modernizing of human resources management—still at a very early stage of

implementation—each area that showed satisfactory progress was narrowly defined and within the control of a single department or agency of the government. Managing the changes needed in the four other areas has been a greater challenge because the changes involve many departments and agencies, take longer to carry out, and demand managers' leadership and persistence to maintain the necessary momentum.

Satisfactory progress

Transport Canada—Overseeing the National Airports System

In 1992, Transport Canada began to transfer the management of major Canadian airports to not-for-profit airport authorities, while retaining ownership of the airports by granting 60-year leases. By 2003, the 26 airports included in the National Airports System had been transferred. Our audit of the system in 2000 found that Transport Canada did not know the financial impact of the airport transfers and had not yet defined its role as owner, landlord, and overseer of the airports in the National Airport System. It could not say whether airport authorities were adhering to the terms of their leases, and it was not overseeing their financial viability.

Since then, Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit. It has almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of transferring airports. It has also clarified and assumed its role as owner, landlord, and overseer of the airports while establishing good working relations with airport authorities.

The Department has determined that airport authorities are complying with the provisions of their leases and maintaining the airport facilities in a condition at least as good as before the transfers. It now monitors annually the financial situation of the airport authorities and oversees the long-term viability of the National Airports System.

Canadian International Development Agency—Financial Compliance Audits and Managing Contracts and Contributions

The Canadian International Development Agency (CIDA) is responsible for managing some $2.6 billion in international development assistance. In 1999 and 2000 audit reports we recommended that CIDA improve its process of awarding contracts and contribution agreements for aid projects. We also said it should document its reasons for deciding not to recover funds in certain cases.

Overall, CIDA has made satisfactory progress in responding to our recommendations. It has made headway in reducing its use of non-competitive agreements, monetizing commodities for deposit to counterpart funds, monitoring project risks, ensuring the sustainability of project benefits, and documenting its decisions on audits of contribution agreements.

However, while conducting our follow-up we became aware of additional weaknesses. For example, we found that although required by policy, CIDA officers rarely analyzed the value of in-kind contributions claimed by recipients or verified that no provision was made for profit. We also noted

that in many cases, CIDA released Canadian executing agencies from their obligation to repay amounts falling outside the terms of their agreements, which means that CIDA did not ensure that it paid only for those goods received and services rendered according to the terms of the agreements.

In the last five years, CIDA has sharply increased its use of grants to fund aid projects; we are concerned this could lead to its sacrificing too much control and oversight over how its funds are spent without having analyzed the impact on results.

Canadian Nuclear Safety Commission—Power Reactor Regulation

The Canadian Nuclear Safety Commission (CNSC) regulates the use of nuclear energy and materials to protect the health, safety, security, and environment of Canadians. This includes the licensing and regulation of nuclear power reactors, which we audited in 2000.

On the whole, the CNSC has made satisfactory progress in responding to our recommendations. It has adopted a consistent approach to compliance and enforcement within and across the divisions that plan and conduct compliance inspections of power reactors. It has developed a new scale to rate how well power reactor licensees meet its regulatory expectations, and it has issued key regulatory documents.

Progress has been slower than planned, however, on developing a formal, well-articulated risk-management approach to regulating nuclear power reactors. In response to our previous audit, the CNSC developed an action plan that it posted on its Web site and updated regularly. The action plan called for the establishment of a risk-based approach by the end of 2003. While the CNSC has adopted this approach in its regulating of nuclear substances and uranium mining and processing, it does not yet follow such an approach for power reactor regulation.

Modernization of Human Resources Management: Managing the Reforms

The legislative framework for human resources management in the federal public service is currently undergoing the most fundamental transformation since the mid-1960s. The new *Public Service Modernization Act*, passed in November 2003, is being phased in over several years, so its full impact will not be evident for some time. Given that it is still in the early stages, implementation is proceeding in an orderly way, and progress is satisfactory.

In my view, the government has laid a solid foundation for carrying out the modernization of human resources management. For the most part, roles and responsibilities have been clarified. However, the Treasury Board Secretariat needs to ensure that the activities of the three agencies that now play key parts of the employer role—the Treasury Board Secretariat, Canada School of Public Service, and Public Service Human Resources Management Agency—are better integrated and co-ordinated. In particular, the role of the new human resources management agency should be further clarified to define its

expected contribution to human resources governance and its relationship to the other stakeholders.

Some of the major organizational changes required by the new legislation have occurred quite smoothly, such as the transfer of certain functions from the Public Service Commission to the Treasury Board Secretariat and the creation of the new Canada School of Public Service. This is largely due to a strong project management process, which has received effective leadership from the deputy minister community.

If this wide-ranging and complex reform initiative is to be successful over the long term, the government will need to maintain its focus and momentum. This will be a challenge, given the many demands on the public service today. The government needs to clearly define the outcomes it expects from the reform of human resources management and then monitor and report on ongoing progress. It also needs to ensure that the full costs of this reform are monitored, controlled, and reported.

Better reporting will be critical in light of the five-year review of the legislation once it comes into effect. Parliamentary committee review of these reports would be a way to influence the nature, direction, and pace of change and also an opportunity to ensure that momentum is maintained and reforms actually take place.

Unsatisfactory progress

Governance of Crown Corporations

Crown corporations control and manage billions of dollars in public funds. It is therefore vital that they be governed well. In 2000, we expressed concern about the governance practices of Crown corporations and made several recommendations for improvement.

In recent years, high-profile failures among publicly traded corporations in North America have prompted many positive developments in corporate governance. Legislation in the United States (the *Sarbanes-Oxley Act*) and more stringent securities regulations in Canada have turned expectations for good corporate governance of publicly traded corporations into requirements. In our view, many of these changes can be adapted to the governance and accountability framework of Crown corporations.

Our follow-up audit examined what the government and Crown corporations have done to implement the recommendations we made five years ago. We found that the overall response has been unsatisfactory. Although individual Crown corporations have made improvements, progress in responding to most of our recommendations has not been as swift or as extensive as we had expected.

It took more than three years for the government to address some of our key 2000 recommendations by starting the Treasury Board Secretariat review of corporate governance in February 2004.

Board, chair, and CEO appointments are still taking too long, and terms are not adequately staggered. In addition, the responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

The changes in the process for appointing directors of Crown corporations, announced in March 2004, have not yet been fully defined or implemented. These changes were put forward by the government to enhance transparency and increase Canadians' confidence that the best people are being appointed to public institutions. Since none of the government's recent appointments have followed the new process fully as of this writing, we could not assess its impact.

On an encouraging note, however, we observed fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

In my view, a range of private sector practices could usefully be emulated in Crown corporations. These include ensuring that the board plays a key role in its own renewal and in selecting the chair and CEO; strengthening the independence of boards and audit committees; requiring that the mandate and operations of the board be defined; strengthening corporate values and ethics practices; and improving the quality of reporting and disclosure.

While these practices are not yet expected of Crown corporations, the Treasury Board Secretariat informs us that it is considering them in the review of Crown corporation governance it is now conducting.

Information Technology Security

In our follow-up audit of information technology (IT) security in government, we noted some encouraging signs of improvement. The development of policies and standards has laid a sound foundation for a more secure IT environment in government. Lead agencies and departments are now more involved and committed.

Overall, however, the government has made unsatisfactory progress in strengthening IT security. Two and a half years after revising its Government Security Policy, it still has much work remaining to translate policies and standards into consistent, cost-effective practices that will result in more secure IT.

IT systems in departments and agencies continue to be vulnerable to breaches in security. The majority of departments do not meet the minimum standards of IT security. Vulnerability assessments conducted in departments and agencies over the last two years have revealed significant weaknesses. If these are exploited, the result could be serious damage to government information systems.

I am concerned that members of senior management are not aware of the risks to IT security in their departments and do not understand how breaches of IT security could affect their operations and the federal government's credibility.

Managing Government: Financial Information

The government continues advancing in its use of accrual financial information and improving the quality of the systems supporting that information. However, more work is needed if departments and agencies are to have better financial information for decision making. Better financial information would also improve financial accountability to Parliament—not just result in improved year-end accrual financial information for preparing the government's summary financial statements. The Office of the Comptroller General of Canada needs to lead this initiative by aggressively advancing the use of accrual financial information and promoting the importance of good internal financial controls.

Departments and agencies must take stronger and swifter action to correct weaknesses in their internal financial controls. Integrated, comprehensive internal control systems have a significant role to play in ensuring that high-quality financial information is available for decision making.

I urge the government to finalize its study of accrual-based appropriations and budgeting at the department level and to move forward in this matter. Without direction and guidance, wider use of accrual financial information in decision making will be delayed still further.

I also encourage the Office of the Comptroller General to finalize a plan for resolving all remaining issues for the fair presentation of departmental and agency financial statements. This will be necessary if the government's goal of having such financial statements audited within five years is to become a reality.

Accountability of Foundations

In 1997 the government introduced a new approach to achieving policy objectives—through the transfer of public funds to foundations, which are non-profit corporations that operate at arm's length from government. At March 2004, more than $9 billion had been paid to such foundations. These upfront payments are made many years before they are needed.

Given the magnitude of these transfers, I have repeatedly expressed concern about the governance and accountability of foundations and the government's accounting for its payments to them.

Our performance audits in 1999 and 2002 found that accountability to Parliament had been placed unnecessarily at risk. The essential requirements for accountability to Parliament were not being met—namely, effective ministerial oversight, adequate provision for external audit, and credible reporting of results. We examined progress in these three areas following the 2003 and 2004 Budget plans, in which the government announced its commitment to improve the accountability of foundations.

Despite some changes for the better, progress overall has been unsatisfactory. Mechanisms for ministerial oversight are not adequate for the government to make adjustments in foundations where circumstances have changed

considerably. There is no provision requiring foundations to undergo performance audits that are reported to Parliament.

Reporting to Parliament and the public has shown some progress. The government is committed to better reporting in the corporate plans, summaries, and annual reports of foundations and in the Estimates documents of sponsoring departments. But the performance information that is provided is not sufficient for effective parliamentary scrutiny, and it needs to be improved.

Conclusion

The purpose of legislative auditing is not to point fingers and issue stern rebukes when problems occur in public sector management. Audits are intended to be learning tools to help management identify things that could be done better and to recommend specific improvements.

Cynics would have us believe that nothing ever comes of our recommendations to the government. In their view, once the Office's reports are made public and the hoopla dies down, the government returns to business as usual.

I beg to differ. The government does pay attention to our reports. And this Status Report bears this out. In four out of eight cases, departments and agencies made satisfactory progress in responding to our recommendations. We are heartened by their achievements and commend their dedication.

In the four cases of unsatisfactory progress, we recognize the complexity and difficulty of the sweeping changes across government that they entail. Nonetheless, these long-standing, challenging issues must be addressed with renewed vigour and with clear plans and strategies. Our audits have shown that success in these cases will need strong leadership and the ability to maintain focus and momentum over long periods of time. In the end, it will be Canadians who benefit from these vital efforts.

Chapter

1

Information Technology Security

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Information Technology Security

Main Points

1.1 Despite encouraging signs of improvement, the government has made unsatisfactory progress in strengthening information technology (IT) security since our audit in 2002. It has laid a foundation by developing IT security policies and standards, and lead agencies and departments are more involved and committed to IT security. However, two and a half years after revising its Government Security Policy, the government has much work to do to translate its policies and standards into consistent, cost-effective practices that will result in a more secure IT environment in departments and agencies.

1.2 The revised 2002 Policy clarified the roles and responsibilities of the various players in IT security. Since then, lead organizations are co-operating to develop standards and provide guidance and assistance to departments in strengthening their IT security practices. However, many standards have yet to be developed and the Treasury Board Secretariat has not completely fulfilled its oversight role as defined in the Policy.

1.3 Departments and agencies have achieved some progress in developing IT security policies and implementing specific security practices, such as vulnerability assessments. However, their IT systems are vulnerable to breaches in security. The majority of departments do not meet the minimum standards set by the Secretariat for IT security. Vulnerability assessments, conducted in departments and agencies over the last two years, have revealed significant weaknesses that, if exploited, could result in serious damage to government information systems.

1.4 We are concerned that, in many departments and agencies, senior management is not aware of the IT security risks and does not understand how breaches of IT security could affect operations and the credibility of the government. If security weaknesses allowed someone to access a database or confidential information, Canadians' trust in the government would be greatly eroded. Further, if a citizen's privacy were violated because of a failure to keep confidential information secure, it could cause that person hardship and seriously undermine the government's efforts to deliver services to Canadians electronically.

Background and other observations

1.5 In 2002, we found that the revised Government Security Policy, which came into effect in February 2002, was an important step in strengthening security across government. However, the IT security standards to support its implementation in departments and agencies were either non-existent or out

of date. Little information on the state of IT security across the government was available because few departments had audited their security programs or monitored their IT security. We also identified other issues that the government needed to address to improve IT security.

Treasury Board Secretariat has responded. The Treasury Board Secretariat's responses to our recommendations are included in this chapter, along with additional information at the end of the conclusion. The Secretariat has responded positively to our recommendations and, in some instances, is already taking action.

Introduction

Cyber incident—Any unauthorized attempt, whether successful or not, to gain access to, modify, destroy, delete, or render unavailable any computer network or system resource.

1.6 In our April 2002 Report, we reported on the state of information technology (IT) security in the federal government. We noted that IT security should be a high priority for management, given increasing cyber incidents and their potential to disrupt an organization's business.

Key findings in 2002

1.7 The 2002 revised Government Security Policy was an improvement over earlier versions of the Policy. More specifically, it

- updated the roles and responsibilities of the Treasury Board Secretariat, which plays a co-ordination and leadership role, and of the 10 entities that provide security guidance and support to departments and agencies; and
- emphasized the importance of IT security to overall government security.

1.8 However, we did have concerns. The operational standards, which departments and agencies follow to implement the policy, were outdated or did not exist. These standards are critical: they define baseline requirements for instituting consistent security measures across government.

1.9 The government was not monitoring how effective the Policy was in strengthening IT security. It had done little monitoring since 1994, and departments and agencies were generally not complying with Policy requirements. The 2002 Policy no longer required departments to audit their security programs every five years and the Royal Canadian Mounted Police to assess departmental security periodically.

1.10 Since 1994, there had been limited government-wide monitoring and oversight of IT security and, as a consequence, little baseline information existed on the state of IT security across government.

Important changes since 2002

1.11 Since 2002, the use of the Internet in government has grown rapidly. It started to accelerate in 1999 with the launch of the Government On-Line (GOL) initiative. GOL will allow Canadians to access key government information and transaction services on-line by the end of 2005.

1.12 To make services and information more accessible, the government has been streamlining its Internet services under three themes: Canadians, Business, and International Visitors. At the departmental level, it is making its services more client-friendly and providing 130 key services on-line. At the same time, three factors are compounding the risk of delivering services on-line:

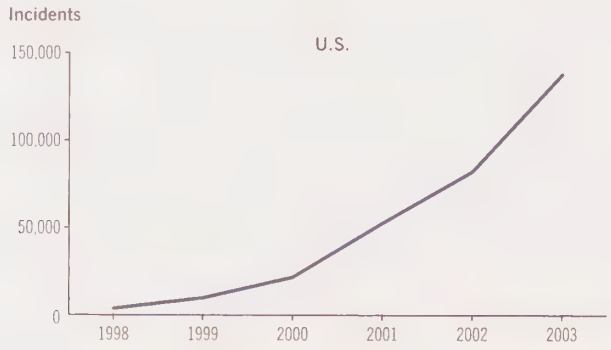
- the availability of on-line tools that can breach the security of IT systems;

- an enormous increase in software and hardware weaknesses that can compromise computer systems and the information they contain; and
- a growing number of people with the knowledge to exploit these weaknesses, often within days of their discovery.

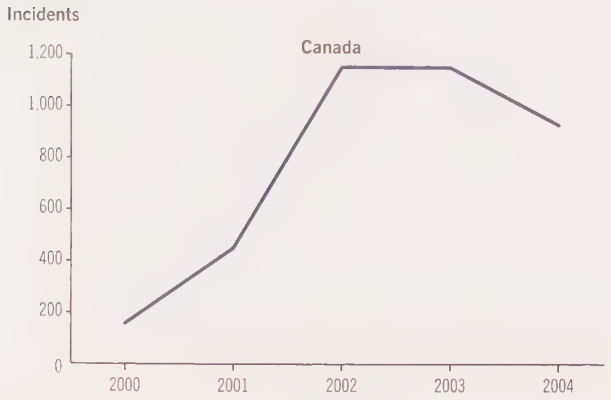
Network attack—A single unauthorized attempt to access or use a network. An **incident**, on the other hand, involves a group of attacks that can be distinguished from other **incidents** by the distinctiveness of the attackers and the degree of similarity of sites, techniques, and timing.

1.13 Cyber incidents have risen significantly since 2001, and the increase and the patterns are similar in Canada and in the U.S. (Exhibit 1.1). However, only a small percentage of incidents are actually reported. Network attacks are a good indicator of the real risks. Since our last 2002 Report, these attacks have increased dramatically, which shows how easily and quickly they can be launched (Exhibit 1.2).

Exhibit 1.1 Cyber incidents detected and reported by third parties in the U.S. and in Canada

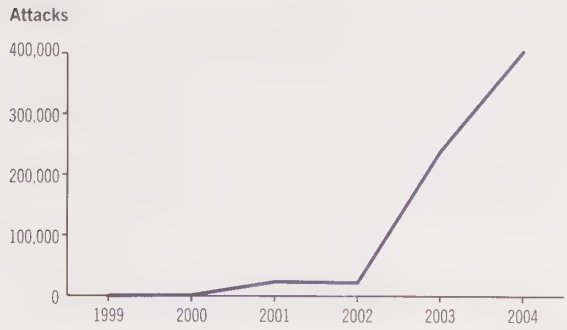


Source: CERT Coordination Centre (U.S.)



Source: CanCERT (Canada)

Exhibit 1.2 Network attacks detected in Canada



Note: These network attacks include a variety of incidents detected by sensors across Canada. They are indicative of the malicious activity that most government and commercial networks experience.

Source: CanCERT (Canada)

1.14 The Government of Canada recognizes that Canadians want on-line services that are secure for business and protect their personal information. In response, it initiated the major Crown project, Secure Channel, an infrastructure that connects Canadians and businesses to the government. The Secure Channel

- incorporates common standards for privacy, security, availability, and reliability;
- offers Internet services to all departments and agencies;
- offers client authentication services, which are being used more and more;
- delivers several GOL services since 2002; and
- will allow Canadians to provide confidential information on their census forms on-line in 2006.

1.15 The government also offers services to users with Web-enabled cell phones or personal digital assistants. The range of these services is increasing. For example, Canadians can now obtain toll-free numbers, up-to-date economic forecasts, or contact information for their members of Parliament.

1.16 Before departments and agencies can deliver their services, either by wireless devices or on-line on the Secure Channel network, they will need to meet stringent baseline IT security standards.

Focus of the follow-up

1.17 The objective of this follow-up was to assess the extent to which the Treasury Board Secretariat and departments have implemented the recommendations that we made on IT security in Chapter 3 of our 2002 Report. We looked at the state of IT security across government, and whether departments and agencies have appropriate frameworks for

protecting the security of information and delivering services securely and without interruption. More specifically, we focussed on five key areas:

- co-operation and information-sharing among lead organizations on IT security;
- development and implementation of IT security standards to support policy;
- effectiveness of the Government Security Policy and existing security measures;
- contingency planning; and
- risk management.

1.18 We interviewed staff from agencies that play a lead role in IT security across government and examined documents and files. In the four departments that we audited in 2002, we reviewed IT security practices in the five key areas noted above. We reviewed a Treasury Board Secretariat survey, conducted a survey of selected IT security practices in 82 government entities, and reviewed the results of technical tests conducted in a number of departments and agencies either by consultants or the Communications Security Establishment. In addition, we conducted our own technical tests. However, we did not examine the Secure Channel and national security matters.

1.19 More information about the follow-up objective, scope, approach, and criteria can be found at the end of the chapter in **About the Follow-Up**.

Observations and Recommendations

A revised Government Security Policy

1.20 The revised Government Security Policy has improved IT security across government, and support exists for further progress.

Roles and responsibilities of lead departments and agencies are outlined in the Policy

1.21 The Policy outlines the roles for the Treasury Board Secretariat and the 10 lead departments and agencies and divides responsibility for security among them. It eliminates duplication in the roles and responsibilities of the Royal Canadian Mounted Police (RCMP) and the Communications Security Establishment (CSE), and adds new roles for Public Safety and Emergency Preparedness Canada (formerly the Office of Critical Infrastructure Protection and Emergency Preparedness).

1.22 In 2002, it was too early to know whether the new roles and responsibilities were appropriate and would eliminate duplication. They are an improvement; the lead organizations, government, and agencies consult regularly on IT security. For example,

- the Information Technology Security Committee meets every two months and is co-chaired by the RCMP and the CSE;

- departmental security officers are briefed throughout the year by lead organizations; and
- senior IT and information management (IM) staff attend the Chief Information Officer Council, an advisory body that discusses IT and IM issues.

1.23 The Policy assigns the Treasury Board Secretariat the main responsibilities of co-ordination, leadership, oversight, and monitoring. However, the Secretariat is not adequately fulfilling its role of monitoring and overseeing the state of security in the government (see paragraphs 1.72 and 1.73).

Government-wide co-operation has improved

1.24 In 2002, we found that the Policy had not defined who was responsible for collecting and sharing best IT security practices across government. This has improved with various mechanisms that contribute to effective information sharing. These include courses organized by the RCMP and the CSE, liaison among chief information officers, and meetings of departmental security officers.

Several IT security standards remain to be developed

1.25 IT security standards stipulate what departments and agencies must do to meet the Policy's baseline requirements. They also promote consistency in security measures across departments and sharing of best practices.

1.26 In 2002, the Policy lacked the operational standards that departments and agencies must meet to comply with its various requirements. Since then, the Treasury Board Secretariat, in consultation with the lead security organizations and departments and agencies, developed the Management of Information Technology Security (MITS) standard, published in May 2004. The MITS standard offers guidance on maintaining secure IT systems in the following areas: management controls, risk assessments, dealing with security incidents and weaknesses in systems, auditing security, and business continuity planning. It also defines the roles and responsibilities of key security officers.

Business continuity plan—A plan for resuming essential business activities following the loss or serious deterioration of an organization's facilities or operations.

1.27 The MITS standard refers to a number of other standards that have not been completed (Exhibit 1.3). When these standards are completed, they, along with the MITS standard, should provide departments with the directives they need to comply with the Policy. The Treasury Board Secretariat has set December 2006 as the target date for complying with the MITS standard.

1.28 **Recommendation.** The Treasury Board Secretariat should complete all the security standards that support the Government Security Policy and the MITS standard. More specifically, it should

- prioritize the IT security standards that have been identified but not yet developed,
- prepare an action plan with timelines for each standard, and
- continuously identify IT security areas where standards are needed.

Treasury Board Secretariat's response. The Treasury Board Secretariat agrees. The MITS (Management of Information Technology Security) standard established an overarching set of baseline requirements for all departments and agencies. In conjunction with the lead security agencies (the Communications Security Establishment, Public Safety and Emergency Preparedness Canada, and the Royal Canadian Mounted Police), TBS will complete the Operational Security Standards before the end of 2006. More technical standards, as well as technical and operational guidance, will continue to be developed to meet the changing needs that reflect our dynamic risk environment.

TBS will develop, co-ordinate, and monitor a GoC-wide plan that will identify priorities among standards not yet developed. As well, a specific action plan for each standard will be produced by the appropriate lead agency and timelines agreed upon with TBS. This broad prioritization and planning in conjunction with the lead security agencies has already begun; the plan will be available to all departments and agencies on our Sitescape forum early in the fiscal year 2005–06.

Emerging IT security issues will continue to be identified by many sources, from lead security agencies and line department security professionals to the business and service delivery owners who have service and system needs to be met. While prioritizing these areas for standards development will be a collaborative effort, TBS will continue to play a GoC-wide co-ordination role, including oversight of the development and implementation of action plans to provide standards and guidance where needed.

Exhibit 1.3 Security standards yet to be completed

IT security standards

- Intrusion Detection
- Incident Management

Other security standards that affect IT security

- Security Training and Awareness
- Security in Contracting
- Identification and Categorization of Assets
- Threat and Risk Assessment
- Investigations and Sanctions
- Security Screening
- Departmental Security Program
- Protection of Employees
- Security Outside Canada
- Sharing of Information

Implementing the Policy

Major inconsistencies in compliance exist

1.29 We expected that departments would generally be complying with most of the Government Security Policy requirements. The core requirements of the Policy and standards have changed little since the mid-nineties. For over a decade, departments have been aware of the Policy and its requirement that their IT systems be adequately protected. However, we found that most departments are not complying fully with the Policy, and major inconsistencies in compliance exist. IT security practices vary in departments; examples are provided in special inserts throughout this section.

The security officer's place in the department

The Government Security Policy and the Management of Information Technology Security (MITS) standard require each department to define the roles of its security officers, in particular for IT security, and give them appropriate status in the organization. The extent that departments have met this requirement varies widely.

- At Industry Canada and Social Development Canada, the roles of the departmental security officer (DSO) and the IT security co-ordinator are clearly defined and follow the MITS standard. However, at Social Development Canada, there is no senior committee responsible for approving policies and standards, and making decisions about IT security. At Industry Canada, the DSO is not positioned strategically to provide strategic and decision-making advice to the organization. In addition, the IT security co-ordinator's function within the Chief Information Officer Branch, which controls only a fraction of the IT budget, does not have sufficient authority in the IT security decision-making process. Because of the limited scope of the two positions, the officers have little influence on department-wide security-related decisions, particularly IT security.
- At Fisheries and Oceans, the DSO does not occupy a position at a strategic level, as required by the Policy. An IT security co-ordinator position does exist and has a functional reporting relationship with the DSO. Given that the Department has many business sectors and regions and that communication between its two security officers is lacking, the Department is not able to develop and implement an integrated and well-co-ordinated security program.

1.30 The Policy requires departments to actively monitor their security programs and audit them. In 2003, the Chief Information Officer Branch of the Treasury Board Secretariat developed a self-assessment questionnaire that departments, in accordance with the MITS standard, must use annually to assess their IT security and security management practices. Departments answer questions about their security policies and practices, based on the Policy's baseline requirements, and are scored against a benchmark.

1.31 The questionnaire helps IT and security staff to better understand baseline IT security requirements, measure their current IT security capacity, and identify gaps between their current practices and best practices. The questionnaire also helps the Secretariat assess the effectiveness of the Policy and standards and assess whether departments are complying with their requirements.

1.32 By early 2004, the Secretariat was concerned that many departments were not implementing the current Policy's IT security requirements. In May 2004, using the questionnaire, the Secretariat surveyed more than

90 departments and agencies. Forty-six entities completed the questionnaire and shared their results with the Secretariat. The results indicate that the Secretariat's concerns were well founded. Of the 46 departments that responded, only 1 met all the baseline requirements of the Policy and standards.

1.33 Departmental IT security policies provide the foundation for meeting the Policy's standards for protecting information and information systems. The Secretariat's survey found that

- 16 percent of departments did not have an IT security policy;
- for those departments that did have one, 33 percent indicated that it had not been formally approved by management;
- 35 percent of departments did not have a policy requiring threat and risk assessments;
- 26 percent of departments did not have a policy requiring a business continuity plan for critical systems and services; and
- 12 percent of departments had not yet identified their critical systems.

Security policies in departments

In 2002, we noted that the four departments we had examined should update their security policies and implement a better governance framework for security. Since then, progress has been uneven:

- Industry Canada has made good progress in developing, implementing, and communicating its IT security policies. It has developed standards and guidance to address IT security issues.
- Senior management at Social Development Canada has yet to formally approve several policies on IT security. As a consequence, they are applied inconsistently across the Department.
- Fisheries and Oceans Canada has made progress in developing a security management framework and specific policies. However, none of these have been formally approved by senior management.
- The National Parole Board has recently started a project to review its IT security policies.

1.34 We developed a brief questionnaire that complemented the Secretariat's self-assessment questionnaire, and focussed on specific IT security practices in departments. We surveyed 82 entities and obtained a response rate of 100 percent. Our results corroborate the Secretariat's findings—major inconsistencies exist between the requirements of the Policy and standards, and the current practice of departments.

1.35 For several areas of security, compliance with the baseline requirements of the Policy and standards was significantly less than adequate. For example, although 65 percent of departments had business continuity plans, only 29 percent had tested them in the last two years.

1.36 The staff that we interviewed suggested various reasons for the gaps in IT security:

- a lack of money and people,
- a lack of interest in IT security by senior management, and
- IT security concerns were not part of the culture in their organizations.

1.37 A general lack of concern for IT security risks leaves systems vulnerable, where weaknesses could be exploited. As a result, sensitive data, including information on the privacy of Canadians, payroll and financial transactions, program information, and other mission-critical data are at increased risk of unauthorized disclosure, modification, or loss—possibly without being detected.

Fostering a culture of IT security in departments

Since we looked at the four departments in 2002, their success in promoting awareness of IT security issues and providing security training has been uneven.

Industry Canada has worked to raise awareness of IT security throughout the Department. It publishes security tips and monthly IT bulletins. It has also developed security training and a process for alerting staff to security incidents. The other departments have not been able to maintain awareness of security throughout the organization or have not been able to maintain the momentum.

1.38 **Recommendation.** The departments and agencies, subject to the Government Security Policy, should prepare an action plan indicating when they intend to fully comply with the IT security requirements of the Policy and with the Management of Information Technology Security standard. This IT security action plan should be approved by the deputy head or designate and reported to the Treasury Board Secretariat.

Treasury Board Secretariat's response. TBS agrees with this recommendation. Discussions have already begun with Information Technology Security Coordinators (ITSCs) to develop individual departmental plans for compliance with the IT security requirements of the Government Security Policy (GSP) and Management of Information Technology Security (MITS) standard. These departmental plans must be submitted to TBS by summer 2005, under the signature of the deputy head or designate, thus ensuring the involvement and commitment of senior departmental management.

1.39 **Recommendation.** The Treasury Board Secretariat should require all departments and agencies, subject to the Government Security Policy, to prepare timely IT security action plans, follow up on these plans shortly after December 2006, and report to the Secretary of the Treasury Board on the organizations that are not complying.

Treasury Board Secretariat's response. TBS agrees with this recommendation in line with recommendation 1.38. TBS will work with the departments and agencies in developing a common review and reporting process with a final report prepared for the Secretary of the Treasury Board in early 2007.

IT security measures should reflect the level of risk

1.40 To protect government assets and information, the Policy follows a risk management approach—a set of practices and procedures to manage risks. Departments and agencies are required to comply with the baseline requirements of the Policy and its standards. In addition, departments are required to conduct a threat and risk assessment to determine whether they need safeguards above the baseline level. The MITS standard requires a threat and risk assessment for "every program, system or service." The assessment can be "simple or far more detailed and rigorous, depending on the sensitivity, criticality or complexity of the program, system or service." The requirement is not new; it was part of the 1994 Government Security Policy.

1.41 Allocating resources according to the degree of risk is a common IT security practice. As mentioned in our 2002 Report, "it is neither feasible nor cost-effective to eliminate all risks or threats to information assets. Moreover, like any priority, IT security has access to limited resources; risk assessments help direct resources to areas that warrant them."

1.42 We were expecting that, in complying with the long-standing requirement of the Policy and its standards, departments and agencies would have done threat and risk assessments to identify risks, and developed strategies for mitigating them.

1.43 In general, departments and agencies have yet to assess threats and risks adequately. Except in the departments where assessments are becoming well-established, they are done inconsistently or not at all. Out of 82 departments and agencies we surveyed, only 37 (45 percent) had performed threat and risk assessments of their programs, systems, or services, as required by the Policy and standards. In addition, only 28 departments had verified that recommendations made in their assessments had been addressed before putting the new programs and systems in place.

Certifying and accrediting systems in departments

The Government Security Policy and its related operational standards require that departments and agencies certify and accredit any new or modified system or application before it is used. Organizations must sign off on the system or application to certify that all the requirements of the risk assessments have been met.

Industry Canada is certifying and accrediting not only new systems and applications that it implements but also major changes to existing ones. Social Development Canada has developed a project life-cycle model that includes certifying and accrediting systems and applications under development. However, IT security is not always taken into consideration at the start of the project. In addition, the risk of failing to meet IT security requirements is increased because senior management, as the project review committee, has not met in over a year.

Fisheries and Oceans Canada and the National Parole Board have yet to comply with this requirement.

1.44 The reasons for not performing threat and risk assessments are unclear. The RCMP has been offering guidance and training for years on how to carry

them out. In 2001, the Secretariat published the Integrated Risk Management Framework to provide departments with guidance on how to take a systematic approach to risk management. Over the last few years, the Communications Security Establishment has also developed methodology and guidance for doing comprehensive assessments. Yet, departments and agencies are not taking full advantage of this support to ensure that their IT resources are well protected in a cost-effective manner.

1.45 Departments and agencies that do not perform threat and risk assessments, as part of their business operations, do not know what risks they are exposed to. As a consequence, if departments and agencies do not consider their IT risks in their risk profile, they may not be directing their efforts and money on the most effective strategies to mitigate their exposure to IT risks, and may not be achieving their objectives.

Exposure—A function of the likelihood that a threat could occur, the consequences if it were to occur, and the safeguards in place.

1.46 **Recommendation.** Senior management in departments and agencies should ensure that IT security risks are included in preparing the corporate risk profile by identifying and assessing the key IT security risks and challenges and determining the level of risk to accept.

Treasury Board Secretariat's response. TBS concurs with this direction, which will encourage departments and agencies to develop an overall corporate risk profile that is reflective of the department as a whole, integrating all risk elements. Senior management oversight will be key to ensuring the success of this way forward. Also refer to recommendation and response 1.47.

1.47 **Recommendation.** The Treasury Board Secretariat should provide departments and agencies with guidance and tools for including IT security as a key component in their corporate risk profile.

Treasury Board Secretariat's response. TBS agrees with this recommendation, which is fundamental to departmental implementation of the Government Security Policy. TBS will work closely with lead security agencies, as well as with line departments, in developing the guidance and tools required to include IT security in an overall integrated corporate risk process, including an updated self-assessment tool.

A key part of this effort is the current project led by the CSE and the RCMP to amalgamate the Threat and Risk Assessment (TRA) guidelines from their respective organizations, thereby providing one common approach that will incorporate both physical and IT security TRA processes. As well, the Security Risk Management standard, planned for completion early in 2005–06, will provide an overall framework for incorporating security risk into the corporate risk profile.

Vulnerability assessments are important in assessing IT security

Vulnerability assessment—A set of procedures to identify and assess weak spots in an organization's security architecture. It uses automated tools to identify if an organization has addressed, or remains exposed to, known security flaws and vulnerabilities in its computing environment.

1.48 Many departments and agencies have carried out vulnerability assessments of their information systems. These assessments complement threat and risk assessments and are done to test systems for particular weaknesses that could compromise security. They do not determine whether

the identified vulnerabilities could be exploited (another test, penetration testing, can determine that). They can be carried out from outside the security perimeter (externally) or within (internally).

1.49 Departments that perform regular assessments often identify weaknesses in networks that had previously been considered to be secure. This happens because new vulnerabilities are continuously being uncovered and exploited with malicious intent. Although many vulnerabilities come from outside an organization, most security incidents (willful or accidental) originate from inside an organization, where individuals have ready access to information and systems.

1.50 We reviewed a number of vulnerability assessments completed by external consultants, the Communications Security Establishment, and our Office (as part of this audit). Most of them revealed significant weaknesses that could be exploited. In some instances, the weaknesses had been exploited and gone undetected. There were also vulnerabilities that had existed for some time in the older versions of products. In such cases, the vulnerabilities cannot be rectified, and the products must be upgraded to ensure adequate protection.

1.51 Exhibit 1.4 shows that 46 departments and agencies (56 percent) from our survey have completed vulnerability assessments in the last two years. The other 36 departments (44 percent) had not completed an assessment in the last two years or had never completed one.

Exhibit 1.4 Organizations that have completed vulnerability assessments over the last two years

Size of organization*	Organizations surveyed	Those that completed one or more assessments	Percentage that completed assessments
Small (under 1,000)	54	27	50%
Medium (over 1,000 and under 10,000)	22	13	59%
Large (over 10,000)	6	6	100%
Total	**82**	**46**	**56%**

*Based on full-time equivalent staff

1.52 We found that the departments and agencies that completed recent assessments had been proactive; they had identified their IT security weaknesses and were prioritizing their efforts to correct those weaknesses. In paragraphs 1.53 to 1.59, we present some of the most important weaknesses reported in the assessments we reviewed. However, we intentionally do not disclose the departments and agencies involved or the exact weaknesses.

1.53 **Access to sensitive data and programs was not adequately controlled.** An important objective for organizations is to prevent

unauthorized people from gaining access to data that support critical operations. Unauthorized access can lead to data being improperly modified, deleted, or disclosed. To effectively control access to data, organizations use software programs to monitor what information on the network is being accessed, and who is accessing it.

1.54 In many cases, the measures to control access to the systems and data were inadequate. We found that the risk associated with weak access controls increased because most organizations did not yet have a comprehensive program for monitoring who was accessing the network.

1.55 **Networks were not secure.** Networks are interconnected devices and software that allow individuals to share data and computer programs. Sensitive programs and data are stored and transmitted on networks. For this reason, networks must be made secure against unauthorized access, manipulation, and use by outsiders. Organizations can secure their networks by limiting the services that are available and installing devices that deny unauthorized requests for access to services and data.

1.56 In many cases, the networks of departments and agencies did not provide a secure operating environment. They used firewalls to protect internal networks from the Internet; however, their current network controls do not provide adequate protection from unauthorized access by outsiders. Without a secure network, departments and agencies are exposed to an increased risk that unauthorized individuals could gain access to sensitive data, and that service could be disrupted or denied.

1.57 **Inadequate network access controls.** Controls that limit access to a network ensure that only authorized individuals in an organization gain access to sensitive and critical data. Effective controls allow only authorized users to access the network from local and remote locations. They also provide safeguards to ensure that users cannot bypass them and cause the network to fail.

Testing for vulnerable passwords

Passwords are used to ensure that only authorized persons gain access to systems. If passwords are not sufficiently robust, they can be compromised by computer programs in what is known as "brute force attacks." Brute force attacks attempt to guess passwords. These attacks can quickly succeed with passwords that

- consist of only a few characters,
- are the same as the account name,
- use the default password,
- use a common word, or
- are derived from personal information that is readily available (such as a person's name, address, or favourite sports team).

Many of the vulnerability assessments that we reviewed found instances where passwords were susceptible to brute force attacks. Some of these vulnerable passwords were protecting access to sensitive entry points in mission critical systems.

1.58 We found that many departments and agencies did not have secure controls in place. In many cases, the devices were not configured to consistently prevent unauthorized access to the systems on their networks.

1.59 The Chief Information Officer Branch of the Secretariat has provided departments and agencies with guidance on how to mitigate potential vulnerabilities on network servers. However, we found weaknesses in areas such as managing passwords and assigning rights and permissions to users. For example, in some departments,

Rights and permissions—The extent to which an individual or device can view, add, change, or delete data on a computer system.

- default vendor accounts and passwords were still active;
- passwords were not set or not set properly;
- staff had broader access than needed; and
- dangerous services, such as remote execute commands, were available.

Testing for weaknesses in configuring systems

Vulnerability exists when an organization installs commercial off-the-shelf software or hardware and does not change the default settings. The default settings are often very permissive so that a new system can be set up easily. It is best practice to remove functions that are not used, and restrict access to a system administrator who, in turn, grants permissions to users to perform activities. The initial default settings that software and hardware vendors provide usually consist of an administrator account name, a standard set of privileges for the administrator, and a password. It is best practice to change these default settings before a new system component is put into use.

The vulnerability tests, performed by departments on their own systems, have identified instances where the manufacturer's default administrator settings had not been changed. Anyone who uses these default settings, to gain access to the system, with administrator privileges effectively has full control over granting access privileges for others and can modify or remove the functions the system performs. This situation presents a serious vulnerability.

Business continuity planning still needs improvement

1.60 The Government Security Policy requires departments to establish a business continuity planning program. The program ensures that all critical services continue to be available in the event of a major disruption, such as a prolonged power failure or natural disaster. Information technology is a major part of an organization's business continuity planning program.

1.61 Valuable information is obtained in business continuity planning from two activities:

- The business impact analysis identifies critical programs, systems, or services, and assigns priority to the ones that should be restored first, if they are disrupted.
- The threat and risk assessment identifies and categorizes information and related assets according to their sensitivity, assesses related threats and system vulnerabilities, determines the level of risk, and recommends safeguards that will reduce this risk to an acceptable level.

1.62 Government operational standards require departments and agencies to perform both activities and, in particular, to carry out threat and risk assessments for every program, system, or service. The requirement to perform business impact analyses is new; we did not examine this area in our 2002 audit.

1.63 In 2002, we examined the business continuity planning program of four departments. None of the departments had updated its plans since preparing for Y2K or tested them periodically. Both activities represent best practices.

1.64 This audit looked at 82 departments and agencies. We examined how they were managing their business continuity planning program and whether the program meets the baseline requirements of the Policy and standards. We did not examine the adequacy of the plans or their tools—the business impact analysis and the threat and risk assessment. We found that several departments and agencies had made progress in instituting their business continuity planning program. However, based on our survey, progress has varied considerably among departments and agencies.

1.65 In our survey, we found that 53 departments (65 percent) had business continuity plans, but only 24 (29 percent) had tested them over the last two years. Periodic testing ensures that these plans remain effective.

1.66 The extent to which the four departments that we audited had updated and tested their business continuity plans and evaluated and mitigated the risks varied. Social Development Canada and Industry Canada had a good updating and testing regime, while the National Parole Board and Fisheries and Oceans Canada did not. Similarly, we found differences in the way departments had clarified roles and responsibilities for business continuity planning. As well, except for the National Parole Board, the other departments had developed improved decision-making mechanisms for developing and implementing their business continuity planning program.

Some departments have yet to start monitoring their security

1.67 The Government Security Policy requires departments to continuously monitor their security program, audit it, and report the findings to the Treasury Board Secretariat. The requirements for ongoing monitoring and periodic reporting provide management with information on whether measures to protect the security of IT systems are adequate and appropriate.

1.68 Prior to 2002, the Policy required departments and agencies to audit their IT security at least every five years. In 2002, we observed that, of some 90 departments and agencies subject to the Policy, only 10 had submitted internal audit reports. Most departments (almost 90 percent) had not complied with the Policy requirement.

1.69 The revised Policy continues to require departments and agencies to monitor their security programs. However, they are no longer required to audit their programs at least once every five years. It is now up to departments to decide how often they will audit their programs, as part of their overall planning process.

1.70 Consequently, we were concerned that departments and agencies would not periodically audit their IT security practices. However, we noted some improvement in this area. Thirty-seven departments and agencies (45 percent) that we surveyed had audited their IT security program in the last two years (as opposed to 10 percent in 2002).

Monitoring security practices in departments

In the four departments we examined, practices for monitoring IT security varied from unsatisfactory to non-existent. We also found that when departments carry out IT security reviews, they do not always correct the problems they have identified. These reviews often revealed a lack of compliance with basic security requirements, such as instituting strong passwords and correcting weaknesses that have been identified.

For example, Social Development Canada has a new process to monitor and respond to IT security incidents, as required by the Policy. However, the Department has not defined what constitutes an IT security incident. This prevents consistent reporting and analysis of incidents, and consistent enforcement of the policies and standards.

1.71 **Recommendation.** Departments and agencies, subject to the Government Security Policy, should provide the Treasury Board Secretariat with an annual schedule of their planned IT security monitoring activities, including self-assessments, vulnerability assessments, and internal audits. They should also provide the Secretariat with a copy of internal audit reports, within three months of completing them.

Treasury Board Secretariat's response. The Internal Audit Policy requires departments to have at least an annual internal audit plan, which must be copied to TBS. This Policy also requires deputy heads to ensure that copies of completed audit reports are provided in a timely manner to the Treasury Board Secretariat. According to the Government Security Policy, the results of internal audits must be reported to the TBS.

TBS agrees with this recommendation, which will require departments and agencies to submit an annual schedule of IT security monitoring activities. Review of these schedules by TBS will provide a level of assurance that departments and agencies are performing ongoing monitoring of their departmental ITS activities and ensure that TBS does receive internal audit reports in a timely fashion.

The Secretariat's oversight of the Policy

1.72 The Treasury Board Secretariat has no formal process in place for getting departments and agencies to submit their audit reports or analyzing the security findings of these reports. Since 2002, the Secretariat has received only 10 audit reports on IT security and has not issued a mid-term report, as required by the Government Security Policy. Internal audit reports can be an important element in developing an overall picture of IT security in departments and agencies.

1.73 The revised Policy requires the Secretariat, as part of its overall monitoring, to submit a report to the Treasury Board on how effective the Policy is in strengthening security. The report was due in the summer of 2004

but has not been produced. As a result, little baseline information exists on the state of IT security across the government.

1.74 **Recommendation.** The Treasury Board Secretariat should monitor departments to determine whether they are carrying out timely audits and other IT security monitoring activities.

Treasury Board Secretariat's response. TBS agrees with this recommendation and will work collaboratively with the lead security agencies and departmental representatives to develop a monitoring process that meets this recommendation and provides adequate information.

TBS will find the most effective way to collect the information required for this monitoring by reusing information that departments and agencies are currently providing and requesting only supplemental information as necessary.

1.75 **Recommendation.** The Treasury Board Secretariat should complete the mid-term report on the effectiveness of the Government Security Policy in a timely manner, as required by the Policy.

Treasury Board Secretariat's response. The mid-term report is scheduled to be presented to the Treasury Board in early 2005.

Conclusion

1.76 Overall, the government has made unsatisfactory progress in strengthening information technology security since our audit in 2002.

1.77 The government has made good progress in several areas that we had previously raised concerns about. The 2002 Policy clarified the roles and responsibilities of the various players in IT security. Since then, lead organizations have consulted regularly and are co-operating to develop standards to strengthen IT security practices. The Policy lacked operational standards for departments to meet its various requirements. Since then, the Management of Information Technology Security standard has been developed, along with some other associated standards.

1.78 However, a number of IT security standards remain to be developed and the Secretariat has not completed its mid-term evaluation of the effectiveness of the Policy. Business continuity planning still needs improvement, and most departments and agencies have yet to assess threats and risks adequately.

1.79 Since 2002, the use of the Internet has increased, and portable computer devices and wireless technologies have made access to information easy and affordable. Government systems are more connected, and the government is aiming for greater inter-operability and integration of its business processes. This environment provides more opportunities for problems to occur, such as theft of data, malicious attacks, or criminal

actions. The threats have increased significantly since 2002, and they can cause serious damage to an organization.

1.80 Despite a stronger Policy, new standards, and other examples of progress, the government still needs to address serious weaknesses in IT security. The majority of departments and agencies are not complying with the baseline requirements of the Policy and the associated standards.

1.81 A lack of compliance with the Policy and standards, a lack of awareness of IT security risks, and a lack of understanding how breaches of IT security could affect operations have broad implications. The risk of security breaches that could violate the privacy of Canadians increases. These violations could cause hardship to individuals and erode the trust that Canadians have in the ability of their government to transact business on-line, in a secure and confidential environment.

Government's overall response. Treasury Board Secretariat (TBS) offers the following information to better explain the context within which TBS and the Government of Canada (GoC) departments and agencies are working.

The GoC operates in a dynamically changing risk environment that requires an active and continuous defence against cyber attacks, viruses, and other internet-related threats. While policy and standards are necessary to establish a common posture and constitute one of the key components of the overall federal ITS response, TBS and the three lead security agencies (namely the Communications Security Establishment (CSE), Public Safety and Emergency Preparedness Canada (PSEPC), and Royal Canadian Mounted Police (RCMP)) are also providing practical assistance and guidance to departments and agencies to help them improve their overall Information Technology Security (ITS) posture and to support their ability to act quickly and co-operatively to prevent, detect, and respond to security breaches across the GoC. Like all large and geographically diverse organizations, the dependence of the GoC on a networked and interdependent environment continues to grow. Such an environment will increasingly require a "collective" approach to effective IT security, wherein a department's ability to respond rapidly to a security incident and share information about it will become the hallmark of an enhanced security organization in the 21st century.

There is a growing requirement for individual departments and agencies, as well as the GoC at large, to be more resilient in the face of rapid technological change. This will require the engagement and co-operation of personnel across organizational boundaries, sharing information on incidents, issues, and solutions.

TBS and PWGSC, in conjunction with the lead security agencies, are also leading the move toward the provision and use of common and shared IT security infrastructures and services. Measures such as Intrusion Detection (ID), Vulnerability Assessment (VA), software maintenance, and system development methodologies are more efficiently implemented in a common centrally managed IT infrastructure rather than department-by-department

solutions. The significant investments made by the GoC in common IT services are an important contribution to more effective security for the GoC's operations and services.

The Secure Channel provides a set of common and secure infrastructure services protecting the delivery of information and transactions for individuals, businesses, employees, and other governments. At this time, 122 departments and agencies are using one or more of the Secure Channel service offerings in support of their on-line service and information delivery. Building and maintaining the trust and confidence of our citizens, businesses, and other governments with whom we do business is fundamental to effective service delivery.

With the publication of the National Security Policy (NSP) in 2004 and the development of processes, committees, and organizational structures to meet the objectives of that Policy, TBS will ensure that departments and agencies follow a strategy that supports the integration and co-ordination of plans, activities, infrastructures, and operations. To this end, projects that enable the pro-active sharing of information and processes both within the GoC and across jurisdictions will be key to this integration.

About the Follow-Up

Objective

The objective of this follow-up was to determine whether the Treasury Board Secretariat and departments had implemented the recommendations we made in Chapter 3 of our 2002 Report. We assessed whether, in general, departments and agencies had implemented IT security baseline requirements to protect information technology assets and deliver services securely and without interruption.

Scope and approach

Our audit focussed on two levels:

- **Lead security agency level.** We focussed on the Treasury Board Secretariat, which provides co-ordination, leadership and oversight for IT security. We also met staff from the Royal Canadian Mounted Police, Public Safety and Emergency Preparedness Canada, the Communications Security Establishment, and the Canadian Security Intelligence Services.
- **Departmental level.** We reviewed selected security practices in the four departments we had examined in 2002: Fisheries and Oceans Canada, Social Development Canada (formerly Human Resources Development Canada), Industry Canada, and the National Parole Board.

We looked at the results of a self-assessment questionnaire that the Secretariat conducted in 97 departments and agencies. The self-assessment was voluntary; only 46 departments and agencies responded. The responses were not corroborated with evidence. We complemented the Treasury Board Secretariat survey with a survey of 82 departments and agencies on specific security practices. We obtained a 100 percent response rate and, to validate the answers, we corroborated the positive answers in a random sample of 20 departments and agencies.

We assessed the safeguards that departments and agencies use to ensure the security of government assets and information. We reviewed the results of vulnerability assessments and technical tests done by consultants, the Communications Security Establishment, and our Office (for three departments) as part of this audit. We ensured that our technical tests did not harm the systems we tested or the data they contained.

We looked at the extent to which the following areas of IT security had improved:

- co-operation and information-sharing among lead organizations on IT security,
- development and implementation of IT security standards to support policy,
- effectiveness of the Government Security Policy and existing security measures,
- contingency planning, and
- risk management.

We did not examine the Secure Channel as, at the time of the audit, it had not yet received effective project approval by the Treasury Board. We did not examine national security matters, which will be the subject of a separate audit on national security enhancement initiatives to be reported in 2005.

Criteria

As in our 2002 audit, we expected that

- the framework for IT security ensures that IT assets and information are protected and supports the secure and uninterrupted delivery of government services;
- the governance structure for IT security ensures strong leadership and support from the central and lead agencies, and consistent, cost-effective IT security practices across government;

- policies, standards, and practices are commensurate with the current state of risks and threats to IT security;
- consistent with assessed risks and current security requirements, departmental measures and processes prevent, detect, and respond to IT threats; and
- IT security practices are monitored and periodically reassessed, and vulnerabilities are addressed.

In addition, we expected that new IT security risks are identified and addressed.

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Chapter

2

Transport Canada
Overseeing the National Airports System

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Transport Canada

Overseeing the National Airports System

Main Points

2.1 Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit.

2.2 Transport Canada has almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of the transfer of the airports in the National Airports System (NAS). The review will determine, among other things, the impact that rent charges have on the viability of the airport authorities and air carriers, and on the government's finances. It will also determine whether the current rent policy is fair to the taxpayers, users, and airport authorities.

2.3 The Department has also clarified and assumed its role as owner, landlord, and overseer of the NAS airports, and established good relations with the airport authorities. The Department found a high level of compliance by airport authorities with the provisions of their lease. The authorities are maintaining the airport facilities in as good or better condition than before the transfer. Also, they are exercising due diligence regarding environmental protection and complying with the lease provisions on public interest and governance.

2.4 Moreover, Transport Canada now monitors the financial situation of the airport authorities annually and oversees the long-term viability of the NAS.

2.5 However, Transport Canada has not kept to the schedule it set for the National Airports Rent Policy Review. The review began in 2001 and was to be completed in fall 2002; it is still in progress. Department officials are aware that the delay could have potentially significant financial impacts on some of the airport authorities.

2.6 Transport Canada does not measure the airports' performance, with the exception of financial data. The Department has not yet identified the areas it needs to measure and has no approved framework showing how it would measure performance.

Background and other observations

2.7 In 1992, Transport Canada began to transfer the major Canadian airports. By March 2003, the 26 NAS airports had been transferred: twenty-two to airport authorities, three to territorial governments, and one to a municipality. Transport Canada retained ownership of the airports transferred to airport authorities in order to guarantee the long-term viability of the NAS. The transfer of the airports to the airport authorities, not-for-profit organizations, was set up as a 60-year lease.

2.8 In our October 2000 Report, Chapter 10, we found that Transport Canada did not know the financial impact of the transfer of the NAS airports. It had not defined its role as owner, landlord, and overseer of the airports; did not know whether the airport authorities were complying with the provisions of their lease; and was not systematically overseeing the financial viability of the NAS.

Transport Canada has responded. The Department agrees with our recommendations and has indicated the actions it plans or has under way to address them.

Introduction

Transport Canada has commercialized the airports in the National Airports System

2.9 In the late 1980s, the federal government started commercializing its air transportation assets. For example, in 1988 Transport Canada privatized Air Canada. These measures were part of a general movement by the federal government to commercialize the transportation infrastructures and enterprises that it operated. In 1992 Transport Canada transferred five of Canada's largest airports to local interests.

2.10 At the time, the only guidance on the airport transfers was a series of guiding principles, approved by Cabinet starting in 1987, and the 1992 *Airport Transfer (Miscellaneous Matters) Act*, which addressed some transfer issues. The 1994 National Airports Policy defined the government's objectives and role for the airports and allowed it to establish the National Airports System (NAS) and a framework for creating and operating Canadian airport authorities.

2.11 One of the key objectives of the Policy was "to ensure a safe, secure and viable National Airports System that will serve Canada in the 21st century." According to the government "local operation and commercialization of the airports will promote cost-efficiency and the provision of services matched to user needs."

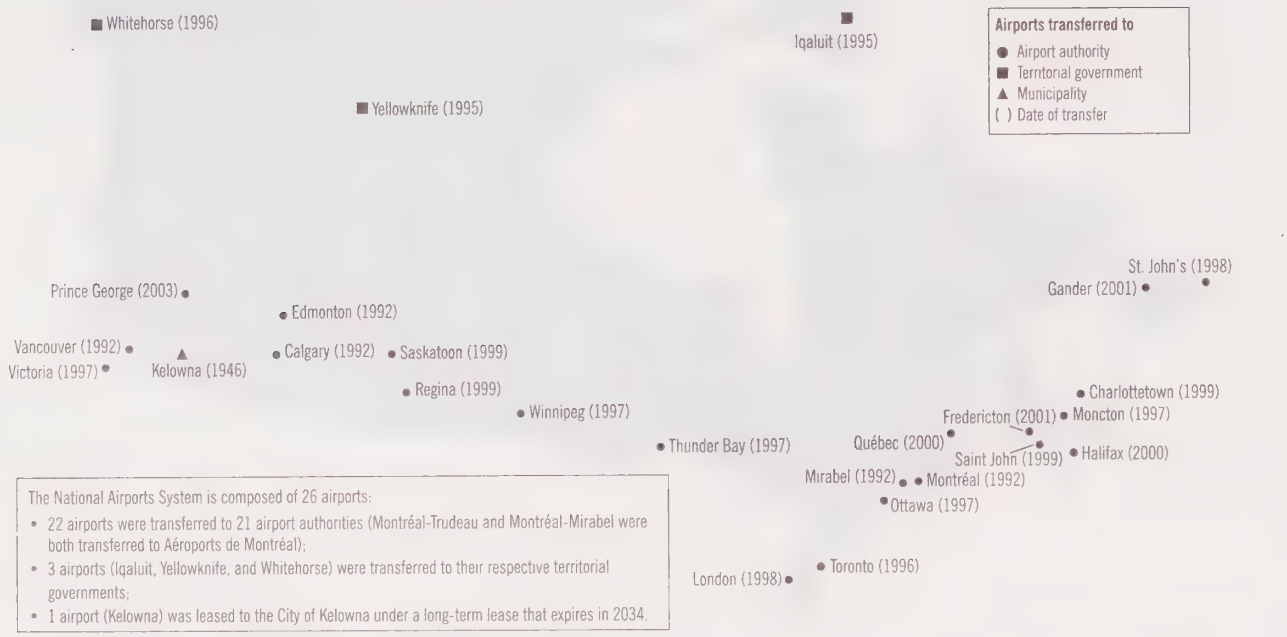
2.12 By the end of March 2003, all 26 NAS airports had been transferred. Twenty-two were transferred to airport authorities, three to territorial governments, and one to a municipality (exhibits 2.1 and 2.2).

2.13 Transport Canada retained ownership of the airports transferred to airport authorities in order to guarantee the long-term viability of the NAS. The transfer to airport authorities, not-for-profit organizations, was set up as a 60-year lease with an option to renew for 20 more years. If the airport authorities and Transport Canada do not reach an agreement by the end of the lease, the airports and all the improvements since their transfer revert back to the federal government, free from any financial obligation.

The National Airports System

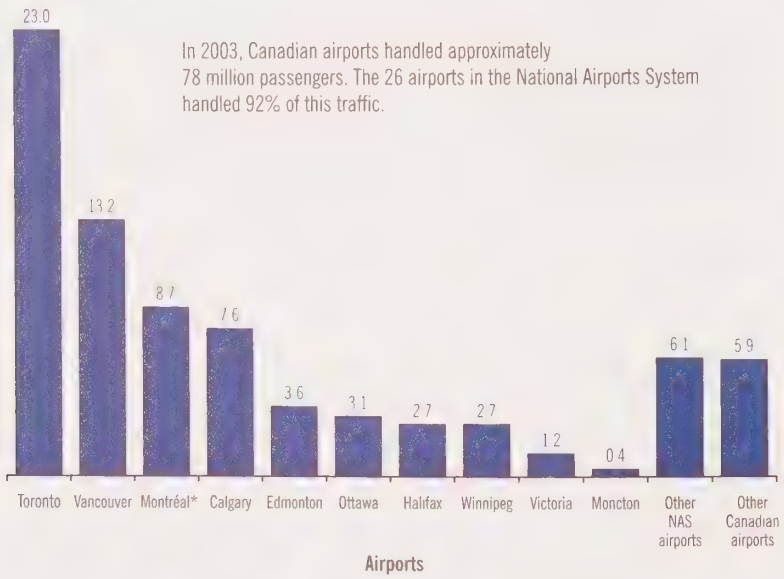
The National Airports System includes the airports that Transport Canada considers "essential to Canada's domestic prosperity and international competitiveness." They are all the airports that, in 1994, handled at least 200,000 passengers and those that are in the national, provincial, and territorial capitals. In 2003, these 26 airports handled 92 percent of Canada's air passengers.

Exhibit 2.1 Canada's National Airports System



Source: Transport Canada, August 2004

Exhibit 2.2 Air passenger traffic in Canada, 2003 (millions of enplanned and deplanned passengers)



* Includes Montréal-Trudeau and Montréal-Mirabel airports, which are under the jurisdiction of Aéroports de Montréal

Source: Statistics Canada

What we found in 2000

2.14 In our October 2000 Report, Chapter 10, we audited the transfer of the airports in the National Airports System by Transport Canada. We found that the Department

- did not know the financial impact of the transfer. Specifically how the transfer affected taxpayers and the long-term viability of the airport authorities, or whether it was fair and equitable for all airports. The Department had not completed its five-year review of the transfer of the first five airports.
- had not defined its role as owner, landlord, and overseer of the airports.
- did not know whether airport authorities were complying with the provisions of their lease in areas such as facility management, environmental protection, and governance.
- was not systematically overseeing the financial viability of the NAS.
- had not determined how to measure the performance of the airports.
- had not reported to Parliament on the impact of the transfer.

Events since 2000

Did you know?

The first Canadian airport to receive its designation as an international airport in 1928: **Winnipeg Airport**

2.15 In November 2001 the Standing Committee on Public Accounts held a hearing on Chapter 10 of our October 2000 Report and produced *Report 21*, which set out its findings and recommendations. Transport Canada responded to the report in October 2002.

2.16 Transport Canada completed the five-year review of the transfer of the first five airports and undertook two major projects. One was to draft legislation on airports and the other was to review the airports rent policy.

- Bill C-27 proposed an economic and governance framework for airport authorities. The Bill was first read in 2003 but died on the order paper at the end of the parliamentary session. The Department plans to revisit the legislation, discuss it with stakeholders, and table it in Parliament, but it has not yet determined when.
- The National Airports Rent Policy Review is examining whether the current policy is fair to taxpayers, the airport authorities, and users and the impact the policy has on the long-term viability of the airports and air carriers. At the time of our audit, the results of the review had still not been presented to Cabinet.

Focus of the follow-up

2.17 This follow-up examined whether Transport Canada implemented our 2000 recommendations on the transfer of the airports in the National Airports System (see paragraph 2.14 for the six observations). More details on the objective, scope, and criteria can be found in **About the Follow-Up**.

Observations and Recommendations

Impact of the transfer of airports

Transport Canada has completed its five-year review of the transfer of the first five airports

2.18 In 2000 we recommended that Transport Canada urgently complete the five-year review that it was to conduct in 1997, at the request of the Treasury Board, and report the results to decision makers and stakeholders. The review was to

- determine the impact of the transfer of the first five airports (Vancouver, Edmonton, Calgary, Montréal-Trudeau, and Montréal-Mirabel), including the financial impact on the federal government and in particular Transport Canada; and
- present recommendations on a framework to govern the long-term relationship between Transport Canada and the NAS airports.



Construction work at Pierre Elliott Trudeau International Airport in Montréal

Source: Aéroports de Montréal

2.19 Transport Canada tabled its final report on the five-year review in 2002, which included all but one of the requirements.

- The Department determined the impact of the transfer, in particular, on service levels and security, and the financial impact on the government.
- It presented recommendations on a governance framework to adopt.
- However, although Transport Canada estimated the impact of the transfer on its budget, it did not include this information in its report.

The review also looked at issues beyond its requirements, most notably, issues on airport authority governance.

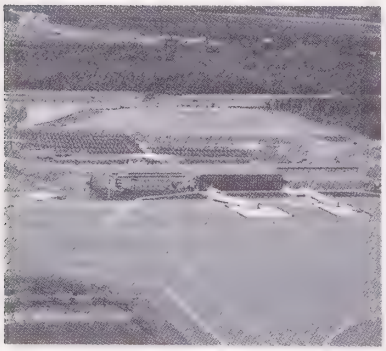
2.20 The Department concluded that the NAS was a success and that the five airports were being operated well. It did, however, note that a number of issues had emerged, in particular the need for airport authorities to be more transparent and accountable and to improve their pricing practices.

Transport Canada has almost completed its assessment of the financial impact of the transfer, but it has not kept to its schedule

2.21 In 2000, we found that Transport Canada did not know the financial impact of the transfer of airports in the National Airports System. Specifically how the transfer affected taxpayers and the long-term viability of the airport authorities, or whether it was fair and equitable for all airports.

2.22 **Review of the National Airports Rent Policy.** One of the main decisions to come out of the five-year review of the transfer of the first five airports was to review the National Airports Rent Policy. The review focusses on the 22 airports transferred to airport authorities and will determine, among other things,

- what impact the policy has on the financial viability of airport authorities and air carriers;
- whether the current policy is fair to taxpayers, airport authorities, and users;



New terminal at the Greater Moncton International Airport

In 2003, the Moncton Airport had the largest percentage increase in passenger volume of all NAS airports.

Source: Moncton Airport Authority and Statistics Canada

- whether the rents payable over the life of the lease provide fair value to the government for the transfer of the airports; and
- what impact the policy has on the competitiveness of the air transportation system.

The review will determine whether the rent policy needs to be changed.

2.23 The Department is completing its assessment of the impact that rent has on the financial viability of the airport authorities and air carriers, one of the key objectives of the review. Rent is a significant percentage of revenue for many airport authorities. In 2003, the Vancouver, Toronto, Calgary, and Ottawa airport authorities paid Transport Canada 19 to 24 percent of their operating revenues in rent. Also in 2003, all the NAS airports paid $241 million in rent. According to the current policy, airport authorities will pay over $1 billion annually in rent starting in 2017 (Exhibit 2.3).

Exhibit 2.3 Rent that airport authorities will pay Transport Canada from 2003 to 2023, under the current rent policy



The significant increase in rent in 2012, 2013, and 2017 is due to a "participation rent," which is added to the rent paid starting in 2012.

Source: Transport Canada

2.24 If the review leads Transport Canada to recommend reducing the rent, it intends to see that an appropriate share of the savings is passed on to the air carriers. The airport authorities have already informed the Department that they agree in principle.

2.25 Another important objective of the review is to determine whether the current rent policy gives the government fair value for the transfer of the airports. Following recommendations from the rent review advisory committee, the Department has separated calculating the value of the airports from determining how much rent to charge. The Department intends to set rents that are fair to taxpayers, airport authorities, and users.

To achieve this goal, it analyzed airport divestitures in the United Kingdom, Australia, New Zealand, and the United States. It also compared the return on investment for its airport leases with the return that regulated industries received— industries like rail transportation, telecommunications, petroleum products transportation, and electricity.

Investing in airports

According to Transport Canada

- the Department invested around $1.1 billion in the airports in the National Airports System when it operated them from 1983 to 1992
- airport authorities invested $6.6 billion from 1999 to 2003

2.26 **Appropriate review procedures.** We feel that the work under way is satisfactory and that the Department has put in place procedures for reviewing the rent policy that take into account its complexity. Before setting the terms of reference for the review in 2002, the Department consulted with stakeholders and took their feedback into account. However, it has not consulted them since that time. We encourage Transport Canada to consult stakeholders on relevant elements of the options under study and keep them up to date from time to time, especially when deadlines need to be changed.

2.27 Before undertaking any necessary studies, the Department made sure that the objectives of the review could be met. It also took into account the objectives when it analyzed different rent-setting formulas. The Department feels that the formula it chooses must be responsive to market changes in air transportation, easy to administer, and fair to all airport authorities.

2.28 For the review, the Department hired consulting firms to assist with technical analyses and financial projections. The Department used proper procedures to select the firms; it assigned work according to technical expertise and in a way that prevented any conflict of interest.

2.29 The Department created an advisory committee made up of representatives from Transport Canada, the Treasury Board Secretariat, the Privy Council Office, the Department of Finance Canada, and the consulting firms hired for the review. In addition to providing a forum for discussion, the committee gives advice and makes recommendations on the consulting firms' technical studies. It has validated key assumptions made in the studies.

2.30 The Department meets regularly with the central agencies. It shares the results of its technical analyses, explains its positions, and gets the agencies' feedback.

2.31 **The Department has not kept to its original schedule.** The review, which began in 2001, was scheduled to be finished in fall 2002 and then in fall 2003. At the time of our audit, the results of the review had still not been presented to Cabinet. Transport Canada attributes the delays to the complexity of the review process and to a series of external events— September 11, the war in Iraq, the SARS crisis, bankruptcy of Canada 3000, and Air Canada placed under the protection of the *Companies' Creditors Arrangement Act*. These events had serious consequences for air transportation and created extra work for the review team.

2.32 Department officials are aware that the delays could have potentially significant financial consequences for some airport authorities. For example, the credit bureaus that establish ratings of the airport authorities take into account the lease conditions with Transport Canada.

The overall impact of the transfer has yet to be assessed

2.33 Transport Canada prepared a framework, as early as 1999, for evaluating the National Airports System. The framework described how the Department proposed to assess the overall impact of the transfer of the NAS airports—not only the financial impact but also the consequences on service and security.

2.34 We noted that the framework is of a good quality, clear, and logical. However, the evaluation has been postponed more than once. The Department wants to begin its evaluation once the proposed legislation on airports has been adopted by Parliament and the review of the National Airports Rent Policy has been completed; we consider this an acceptable approach. The Department intends to update the framework so that the next evaluation focusses on the impacts of these initiatives on NAS airports.

A new role for Transport Canada

Transport Canada has clarified its role for the National Airports System

2.35 In our 2000 audit, we were concerned that Transport Canada had yet to clearly define its role and responsibilities as owner, landlord, and overseer of the National Airports System.

2.36 We found that Transport Canada has since clarified the role it intends to play:

- monitoring the operation of the NAS,
- protecting federal property leased to airport authorities, and
- promoting good governance by airport authorities.

This role was defined in the proposed legislation on airports.

2.37 The Department has clearly communicated its role and responsibilities to the airport authorities, and airport executives understand the Department's responsibilities well. Also, Department staff clearly understand Transport Canada's role and responsibilities.

Transport Canada has established good relations with the airport authorities

2.38 In order to carry out its responsibilities properly, especially in overseeing the airport authorities, Transport Canada needed to establish good relations with the airport authorities. The airport executives that we interviewed confirmed that they enjoy good relations with Transport Canada managers and staff.

The draft legislation on airports was not adopted

2.39 The proposed legislation on airports was drafted by Transport Canada in response to its five-year review. The legislation proposed a framework for the economic activities of the airport authorities and for governance. It addressed a number of issues that the five-year review and our 2000 audit had raised (Exhibit 2.4). We found that the legislation included most features of a governance framework.

2.40 The draft legislation had its first reading in 2003 but died on the order paper at the end of the parliamentary session. Although the leases incorporate a number of features of a governance framework (see Exhibit 2.4), other features, such as a process for resolving disagreements about airport fees between airport authorities and air carriers, are still missing. The Department plans to revisit the legislation, discuss it with stakeholders, and table it in Parliament at an undetermined time.

Exhibit 2.4 The proposed 2003 *Canada Airports Act* addressed most of the governance issues that the five-year review and our 2000 audit had raised

Some of the features of a governance framework	Five-year review of the transfer of the first five airports	Our 2000 audit	Proposed 2003 *Canada Airports Act*	Airport authorities' ground lease
Clear definition of federal roles and responsibilities	●	●	●	●
Consultation, transparency, and access to information on airport authorities	●	●	●	●
Airport authorities' audited financial statements included in their annual reports		●	●	●
Five-year performance reviews of airport authorities conducted by independent consultants	●	●	●	●
Framework for determining airport fees	●	●	●	
Process for resolving disagreements over airport fees	●	●	●	
Framework for subsidiaries of airport authorities	●	●	●	
Disclosure of major contracts not awarded under a public bid		●	●	●

Lease monitoring

The lease monitoring program is firmly in place

2.41 The ground lease is the main tool that defines the obligations of Transport Canada and the airport authorities. It contains provisions that airport authorities must follow, in areas such as governance and public interest, the environment, safety and security, and facility management.

Good practice

For the past few years, the Greater Toronto Airports Authority and Aéroports de Montréal have been certified ISO 14001, which is an internationally recognized standard for environmental management.

2.42 The lease stipulates that Transport Canada can audit the airport authorities without restrictions. In 2000, we found that the Department had not exercised this right and did not know to what extent the authorities were complying with key provisions in their lease. Therefore, it was not able to report to Parliament on this matter.

2.43 Since then, the Department has developed a rigorous lease monitoring program that assesses the airport authorities' compliance with their lease provisions.

2.44 At the time of our audit, the Department had conducted three annual assessments and was in the process of conducting a fourth for 2004. Ottawa headquarters provides support to the regional offices, especially with interpreting the lease provisions to ensure that they are applied equally across Canada. The regional offices carry out the lease monitoring program. The Department assesses the airport authorities' compliance with each clause of the lease (Exhibit 2.5). The annual assessments mean that concerns raised by each party can be dealt with promptly.

Good practice

To familiarize staff at Transport Canada's headquarters on issues that airport authorities face, the Ottawa Airport Authority offered training on, among other things, governance, how to plan an airport expansion project, and how airlines view airports.

2.45 When we visited the regional offices, staff told us that they were satisfied with support from headquarters. For instance, headquarters developed

- a comprehensive training plan that covers most aspects of lease monitoring—staff were satisfied with the training and found the topics relevant; and
- in collaboration with the regions, a procedures manual and checklists that facilitate monitoring.

2.46 The five regional offices responsible for lease monitoring must produce a report for each airport authority they cover. Monitoring includes reviewing documents, attending public meetings, and visiting the airports. We found that the information collected by the regional offices supports the observations made in the reports. Overall, the files we examined were complete and the documentation was adequate.

Exhibit 2.5 Sample clauses in the ground lease of airport authorities

Governance and public interest

The airport authority shall hold an annual public meeting on the management of the airport and give prior notice of the meeting at least 30 days in advance.

The airport authority shall publish an annual report including its audited financial statements.

The airport authority shall list in its annual report all contracts over $75,000 that were not awarded under a public bid solicitation process.

Environment

The airport authority shall adopt an Environmental Management Plan and update it as the need arises.

Safety and security

The airport authority shall comply with federal safety and security regulations.

Facilities

The airport authority shall, at a minimum, undertake to ensure adherence to the National Building Code and the National Fire Code during all construction work.

Plans and future infrastructure

The airport authority shall adopt an Airport Master Plan and a Land Use Plan.

Environmental monitoring by airport authorities



Air quality monitoring near Toronto's Pearson International Airport

Source: Greater Toronto Airports Authority



Noise monitoring near Calgary International Airport

In 2002–03, the Calgary Airport Authority hired a consultant to determine whether its operations were in compliance with environmental regulations and its own environmental management system.

Source: Calgary Airport Authority

Transport Canada has found the right balance in how it manages the lease monitoring program

2.47 In our 2000 report, we noted that the Department had adopted a hands-off approach as landlord and overseer of the NAS. Since that time, while recognizing that the management and operation of the airports fall exclusively within the airport authorities' jurisdiction, the Department clearly indicated that it intends to assess the authority's compliance with their lease. The Department has found the right balance between a passive approach and interfering in the airports' activities; it exercises due diligence and tries to minimize the impact its monitoring has on the authorities.

2.48 The Department's approach, however, does not systematically address the risks of non-compliance with the lease. Department employees tend to conduct informal risk analyses. This approach may work when the employees who participate in the lease monitoring are knowledgeable and very experienced, which is generally the case. However, Transport Canada officials are aware of the merits of a more systematic approach to risk management and lease monitoring. The Department is currently working on such an approach, which could help employees, especially those with less experience, identify provisions of the lease that need closer scrutiny.

Transport Canada has noted a high level of compliance among the airport authorities with their lease provisions

2.49 With its lease monitoring program, the Department is now able to assess the extent to which airport authorities comply with the provisions of their lease. The Department noted that the airport authorities comply with all the key provisions. In its national summary report for 2003, Transport Canada concluded that the airport authorities are

- maintaining the airport facilities in as good or better condition than before the transfer;
- exercising due diligence with regard to environmental protection;
- complying with lease provisions on public interest and governance—they are holding annual general meetings, producing annual reports, and preparing five-year performance reviews; and
- aware of safety and security, and comply with all the regulations and standards applicable to their certification.

Transport Canada did not find any situations of non-compliance that would have forced it to serve a default notice on any of the airport authorities.

Overseeing the financial viability of the airports

Transport Canada is overseeing the financial viability of the NAS

2.50 In 2000, we observed that Transport Canada was not systematically overseeing the financial viability of the NAS. The National Airports Policy states that "by retaining legal ownership of NAS airports, the federal government will be able to guarantee the integrity and long-term viability of the vital NAS system." To achieve this goal, the Department must collect and analyze reliable financial data on the NAS airports.

Good practices

- The Vancouver Airport Authority, which owns subsidiaries in areas such as airport management, disclosed financial data and information on its subsidiaries in its *2003 Annual Report*.
- The Halifax, Ottawa, Moncton, Victoria, Edmonton, and Toronto airport authorities explained in their 2003 annual reports what the airport improvement fees they collected were used for. The revenue collected from airport improvement fees is meant to fund airport infrastructure construction.
- In their 2003 annual reports, the Edmonton and Ottawa airport authorities disclosed the credit ratings they received from the credit bureaus who analyzed their financial status.

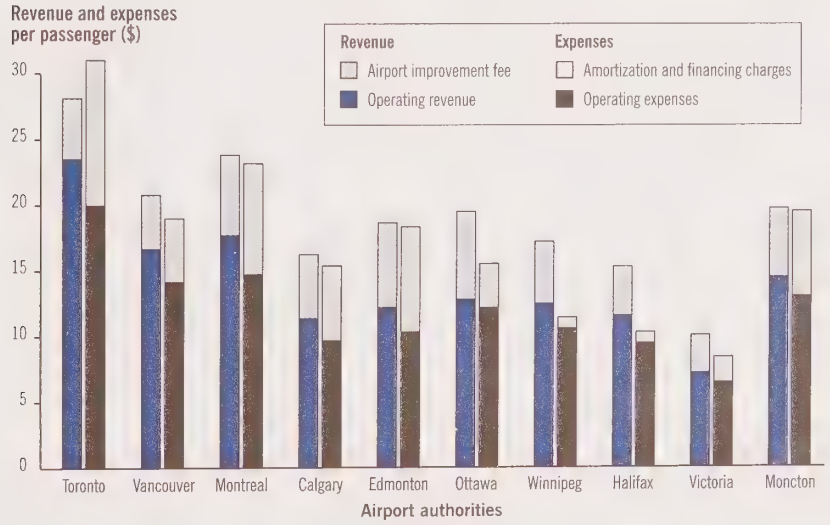
2.51 The Department is now monitoring annually the financial situation of the airport authorities. It receives the authorities' audited financial statements, as stated in the lease, and analyzes them. Exhibit 2.6 shows the revenue and expenses per passenger for 10 airport authorities for 2003. The appendix is a summary of the financial results of these airport authorities.

2.52 The Department also collects information on the authorities' subsidiaries. When necessary, it conducts spot checks of any airport authority whose financial situation raises concerns.

2.53 Over the last two years, the Department has overseen the long-term financial viability of the airport authorities, with data collected from the Airports Rent Policy Review. The review allowed the Department to establish financial projections for the next 20 years for the airport authorities. While the Department has paid close attention to the quality of the data used, it has not determined how it will continue to monitor the long-term financial viability of the authorities once the data becomes obsolete.

2.54 Also, Transport Canada has not developed a comprehensive strategy for responding in the event that an airport authority encounters serious financial difficulty. Although the Department would have no liability if this happened, a strategy would help it respond quickly if necessary. The Department recently developed a discussion paper on the subject.

Exhibit 2.6 Revenue and expenses per passenger for 10 airport authorities in 2003



Source: Transport Canada

2.55 Recommendation. Transport Canada should clarify how it will continue overseeing the long-term viability of the NAS once the data from the Airports Rent Policy Review becomes obsolete. In particular, it should determine what data to collect; who will collect it, how often, and how it will be collected; and how the results will be used.

Transport Canada's response. To determine if policies and frameworks are working as intended and to provide "early warning" indicators of potential financial trouble at an airport, the Department intends to build upon the work it did assessing the long-term viability of the leased NAS airports for the Rent Policy Review. To facilitate this, the existing forecast model would be updated, on an ongoing basis, with current financial and traffic data.

2.56 **Recommendation.** Transport Canada should develop a comprehensive strategy for responding in the event that an airport authority encounters serious financial difficulty. In particular, the strategy should state who in the Department would assume primary responsibility, when the Department would intervene and the methods it would use, and the legal limits of the intervention.

Transport Canada's response. Transport Canada concurs. As noted in the Department's discussion paper, serious financial difficulty can arise from a variety of underlying causes, which may accordingly require different skill sets (finance and accounting, policy, operations, etc.). The Department will develop a variety of case scenarios to ensure it can

(i) assign primary responsibility in any foreseeable case;

(ii) marshal the necessary information for decision makers to decide whether to intervene, and if so, how; and

(iii) identify the legal and financial authorities the Department has or would have to obtain for such a case.

Transport Canada conducted a study of the financial situation of the regional airports

2.57 Transport Canada conducted the Regional and Small Airports Study, following a request by Cabinet to find out how the sale of these airports to local interests had affected their financial situation.

2.58 Since Transport Canada sold the regional airports, it no longer has to guarantee their viability. However, the Department needs a minimum of information on the financial situation of the major regional airports, so it can factor in the potential impacts of the airports' financial situation on the vitality of the air transportation system, and report to decision makers and Parliament.

2.59 The study, recently completed, has provided up-to-date information on the financial situation of the major regional airports. However, the Department has not considered how it could continue to monitor their financial situation.

2.60 We encourage Transport Canada to determine how it will monitor the financial situation of the major regional airports. Among other things, the Department needs to identify the airports to monitor; determine what data to collect, who will collect it, how it will be collected, and how often; and how the results will be used.

Measuring the performance of the airports



Transportation in Canada, a report tabled annually in Parliament, is used by Transport Canada to present information on the state of transportation in Canada.

Transport Canada does not measure the performance of the airports

2.61 In 2000, we observed that Transport Canada had not determined how to measure the performance of the airports; we recommended that it design a framework to do this.

2.62 Over the past few years, and particularly in its *2000–01 Report on Plans and Priorities*, Transport Canada has made efforts to determine what kind of performance information about the Canadian airports would be useful for departmental decision makers, members of Parliament, airport authorities, and stakeholders. In its draft legislation on airports, the Department included sections on measuring performance, notably the requirement for airport authorities to establish performance indicators.

2.63 However, the Department has not identified the areas of airport performance it needs to measure or how it will use the information. Also, it has not approved a framework to show how it expects to do it. The Department needs to finalize the framework, as soon as possible, so it can let the airport authorities know the areas of performance it wants to measure and the indicators it plans to use, especially if it relies on information from the authorities.

2.64 The only data on airport performance that Transport Canada provides, in its report *Transportation in Canada*, is on finances and passenger volume. For example, *Transportation in Canada* and the Department's performance report do not contain information on the level of service offered to the public by the airports.

2.65 **Recommendation.** Transport Canada should

- develop a framework identifying the airports whose performance it wants to measure; what it needs to measure; what data it needs to collect, who will collect it, how it will be collected, and how often; how it will use the results; and how it will report on the performance;
- have the framework approved by departmental executives; and
- start, as soon as possible, collecting data, measuring the airports' performance, and reporting on the results.

Transport Canada's response. Transport Canada recognizes the importance of developing and implementing a performance-monitoring framework. This was reflected in early drafts of a proposed legislative framework for airports (2003). To ensure that airport business dynamics and data availability are taken into consideration, this project would be developed in consultation with the relevant airports to identify and prioritize appropriate performance measures. The Department will enhance its data gathering capabilities, as well as determine the best approach to report the results.

Collecting air transportation statistics electronically to reduce time and cost

Statistics on passenger volume are essential for measuring the current performance of the airports and establishing financial projections for the airport authorities. Transport Canada launched its Electronic Collection of Air Transportation Statistics initiative to help air carriers collect data more easily and send them to the Department electronically, to substantially shorten the time it takes to collect the data, and to reduce the cost to industry and the government. The Department expects that, by the end of March 2005, the majority of air carriers serving Canadian airports, including foreign carriers, will participate in this initiative.

Accountability

Transport Canada has reported to Parliament on the transfer of the airports

2.66 In 2000, we recommended that Transport Canada report to Parliament, on a timely basis, on the impact of the transfer of the NAS airports. Transport Canada has since provided information to Parliament on the transfer in its reports on plans and priorities, performance reports, and *Transportation in Canada*. Specifically, the Department has reported on its five-year review of the transfer of the first five airports and on the key measures it developed as a result of the review—the proposed legislation on airports, the National Airports Rent Policy Review, and the lease monitoring program.

2.67 The Department has also reported to Parliament on the short-term assistance it provided airport authorities in 2003. We expect that once the results of the Airports Rent Policy Review are known, the Department will provide a timely report to Parliament that highlights the financial impact for the government, airport authorities, and users.

2.68 However, in recent years, the public has not found it easy to obtain information on the airport transfers. In 1999, Transport Canada summarized the preliminary findings of its five-year review for its consultations with stakeholders. The Department did not post the summary on its Web site, which would have made it easier for members of Parliament, stakeholders, and Canadians to consult it. Similarly, none of the studies on the Airports Rent Policy Review had been posted on Transport Canada's Web site, as of November 2004, even though the Department does intend to post studies that do not contain confidential information.

2.69 The Department has recently added a number of documents of interest to its Web site: the consultation paper on the five-year review, the terms of reference for the National Airports Rent Policy Review, and the Regional and Small Airports Study.

2.70 We encourage Transport Canada to make it easier for members of Parliament, stakeholders, and Canadians to obtain information on the transfer of the airports and on their performance, notably by posting documents on its Web site.

Where can I find information on the airport authorities?

In our audit, we examined Transport Canada's records on 10 airport authorities. These airport authorities have Web sites that inform visitors about their organization and offer various documents including annual reports. The Victoria Airport Authority, for example, has a Web site where Canadians can easily find information on governance.

Conclusion

2.71 Transport Canada has made satisfactory progress in implementing the recommendations of our 2000 audit.

2.72 We found that Transport Canada has done the following:

- Almost concluded the National Airports Rent Policy Review, which will allow it to assess the financial impact of the transfer of the airports in the National Airports System. The review will determine, among other things, the impact that rent charges have on the viability of the airport authorities and air carriers and on the government's finances. It will also determine whether the current rent policy is fair to taxpayers, users, and airport authorities.
- Clarified and assumed its role as owner, landlord, and overseer of the airports, and established good relations with the airport authorities.
- Established a lease monitoring program. The Department found a high level of compliance by airport authorities with the provisions of their lease. The authorities are maintaining the airport facilities in as good or better condition than before the transfer. Also, they are exercising due diligence regarding environmental protection and complying with the lease provisions on public interest and governance.
- Started to monitor the financial situation of the airport authorities annually and oversee the long-term viability of the NAS.
- Reported to Parliament on the transfer of the NAS airports.

2.73 However, Transport Canada has not kept to the schedule it set for the National Airports Rent Policy Review. The review began in 2001 and was to be completed in fall 2002; it is still in progress. Department officials are aware that the delay could have potentially significant financial impacts on some of the airport authorities.

2.74 Also, Transport Canada does not measure the airports' performance, with the exception of financial data. The Department has not yet identified the areas it needs to measure and has no approved framework showing how it would measure performance.

About the Follow-Up

Objective

The objective of the follow-up was to evaluate the extent to which Transport Canada implemented the recommendations of our October 2000 Report, Chapter 10, on the transfer of the airports in the National Airports System. These recommendations are listed in paragraph 2.14.

Scope and approach

We examined the measures that Transport Canada had adopted to

- assess the financial impact of the transfer of the NAS airports;
- oversee the financial viability of the NAS;
- measure the airports' performance;
- report the findings to Parliament; and
- monitor the airport authorities' leases (we examined Transport Canada's files on 10 airport authorities: Victoria, Vancouver, Edmonton, Calgary, Winnipeg, Toronto, Ottawa, Montréal, Moncton, and Halifax).

We did not examine issues of airport safety and security.

We met with Transport Canada staff in Ottawa, Vancouver, Edmonton, Winnipeg, Toronto, Montréal, and Moncton. We also discussed the National Airports Rent Policy Review with officials from the Department of Finance. Last, we met with officials from a number of airport authorities and air transportation organizations.

Criteria

We expected that Transport Canada

- had clearly defined its roles and responsibilities for the National Airports System;
- had observed sound management practices in managing and administering agreements with the airport authorities and for the National Airports System as a whole;
- had kept abreast of new developments to safeguard public assets and protect taxpayers' interests; and
- was monitoring and analyzing the results and impact of the airport transfers, the workability of the National Airports System, and the maintenance of leased facilities, and reporting these matters to decision makers and Parliament.

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Appendix Financial results of 10 airport authorities in 2003 ($ thousands)

	Toronto	Vancouver	Montréal	Calgary	Edmonton	Ottawa	Winnipeg	Halifax	Victoria	Moncton
Consolidated statement of operations (for the year ended 31 December 2003)										
Aeronautical revenues	360,434	99,469	67,395	47,805	25,567	21,921	18,591	17,492	3,433	3,363
Non-aeronautical revenues	180,572	120,610	87,466	39,160	18,732	17,912	14,820	14,054	5,172	2,925
Operational revenues	541,006	220,079	154,861	86,965	44,299	39,833	33,411	31,546	8,605	6,288
Airport improvement fees	105,857	54,437	53,525	37,341	23,326	20,838	12,672	10,199	3,465	2,288
Total revenues	646,863	274,516	208,386	124,306	67,625	60,671	46,083	41,745	12,070	8,576
Rent to federal government	125,211	66,300	4,805	23,408	2,358	11,329	3,755	3,191	1,096	-
Salaries and wages	85,504	30,485	38,889	10,477	12,893	10,066	11,780	10,399	2,419	1,910
Other operating expenses	249,353	90,091	85,179	40,188	22,222	16,465	12,797	12,218	4,214	3,741
Operational expenses	460,068	186,876	128,873	74,073	37,473	37,860	28,332	25,808	7,729	5,651
Interest and financing charges	157,086	22,184	26,612	13,751	14,655	4,682	-	-	873	1,684
Amortization	96,479	41,957	47,138	29,712	14,354	5,724	2,284	2,307	1,465	1,141
Total expenses	713,633	251,017	202,623	117,536	66,482	48,266	30,616	28,115	10,067	8,476
Settlement of a lawsuit relating to Château Mirabel	N/A	N/A	20,670	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Net income (net loss)	**(66,770)**	**23,499**	**(14,907)**	**6,770**	**1,143**	**12,405**	**15,467**	**13,630**	**2,003**	**100**
Consolidated balance sheet (as at 31 December 2003)										
Total assets	5,872,430	936,203	1,122,643	634,609	324,428	381,547	78,749	62,125	31,128	31,850
Long-term debt	5,571,623	305,664	800,000	370,000	248,957	274,198	-	6,026	13,214	26,065
Total liabilities	5,871,256	358,845	945,640	415,584	264,636	302,811	8,957	13,844	15,054	27,657
Total net assets	**1,174**	**577,358**	**177,003**	**219,025**	**59,792**	**78,736**	**69,792**	**48,281**	**16,074**	**4,193**

Source: Transport Canada and airport authorities' 2003 annual reports

Chapter

3

Modernization of Human Resources Management

Managing the Reforms

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Modernization of Human Resources Management

Managing the Reforms

Main Points

3.1 The government is making satisfactory progress in the early stages of its implementation of a new legislative framework for human resources management in the federal public service. The new framework will not be fully implemented until December 2005 at the earliest, and the full impact of the changes will not be evident until several years later. This is the most significant legislative change to the framework since the mid-1960s. The government has established a good foundation for the management of its human resource reforms, and we found leadership and a sense of purpose.

3.2 For the most part, roles and responsibilities for human resources management have been clarified. However, the Treasury Board needs to ensure that the three agencies that now carry out the various aspects of its role as employer (the Treasury Board Secretariat, the Public Service Human Resources Agency, and the Canada School of Public Service) integrate their activities more formally and fully. In particular, the role of the new Public Service Human Resources Management Agency of Canada needs to be further clarified to define its expected contribution to human resources governance and its relationship to the other stakeholders.

3.3 Some of the major organizational changes required by the legislation (the transfer of certain functions from the Public Service Commission and the creation of the Canada School of Public Service) occurred relatively smoothly. A strong project management process has been put in place to manage the many changes needed, and it has received strong leadership from the deputy minister community.

3.4 As the full impact of changes envisioned by the legislation will take some years, the government will need to maintain the focus and momentum of this significant reform initiative. This will be a challenge given the many demands on the public service today. The government needs to clearly define the outcomes it expects from this reform, and it needs to monitor and report on ongoing progress. It also needs to ensure that it monitors, controls, and reports on the full costs of this reform.

Background and other observations

3.5 Parliament passed the new *Public Service Modernization Act* in November 2003. The Act made significant amendments to four related pieces of legislation affecting human resources management in the public service: the *Public Service Employment Act*, the *Financial Administration Act*, a new *Public Service Labour Relations Act* (replacing the *Public Service Staff Relations Act*), and the new *Canada School of Public Service Act* (replacing the *Canadian Centre for Management Development Act*).

The departments have responded. The Treasury Board of Canada Secretariat, the Public Service Human Resources Management Agency of Canada, and the Public Service Commission have generally agreed with our recommendations.

Introduction

A call for a new human resources management regime

3.6 The federal public service delivers programs and services to Canadians and provides advice to ministers and officials on a wide range of matters. The salaries and related costs of maintaining a public service are a major government expenditure. Given the major changes occurring in the public service in terms of a shift in the nature of work, its demographics, and an increasingly tight market for talent, the government must be able to manage its human resources effectively. The public service needs to be organized and well managed in order to maintain its tradition of excellence.

3.7 In our April 2000 Report, Chapter 9, Streamlining the Human Resources Management Regime: A Study of Changing Roles and Responsibilities, we noted long-standing concerns about the fragmentation of roles and responsibilities for human resources management in the federal public service. We also noted, as we had in a number of previous reports, that the current human resources management regime was cumbersome, complex, inflexible, and outdated.

3.8 The Public Accounts Committee held hearings on this matter in 2000 and 2001 and recommended a legislative review to streamline the staffing function, clarify the roles and responsibilities of the various stakeholders, and generally modernize human resources management.

3.9 In April 2001, the government indicated its intent to reform the public service and, to that end, initiated a two-pronged approach to modernizing human resources management, including legislative and non-legislative changes. The Prime Minister announced the formation of the Task Force on Modernizing Human Resources Management in the Public Service. Its mandate was to recommend a modern institutional framework for managing human resources. The Clerk of the Privy Council listed three guiding principles as the foundation for reforms: protecting the merit principle, delegating human resource management matters to the lowest possible managerial level, and ensuring that managers were accountable for results. The work of the Task Force resulted in the tabling of the *Public Service Modernization Act* in February 2003. It received royal assent on 7 November 2003.

A summary of legislative changes

3.10 The new *Public Service Modernization Act* (PSMA) made significant changes to the existing legislative framework. Part 1 of the Act replaces the *Public Service Staff Relations Act* with the *Public Service Labour Relations Act* (PSLRA). The changes reflect many of the recommendations of the 2001 report on labour management relations, *Working together in the Public Interest* (the Fryer Report). For example, the new PSLRA calls for labour relations based on greater co-operation and consultation between the employer and bargaining agents. It establishes the Public Service Labour Relations Board as a mechanism for resolving disputes. The new Board replaces the old Public

Service Staff Relations Board but has a broader mandate, including a compensation research function and increased mediation services.

3.11 Part 2 of the PSMA amends the *Financial Administration Act*. It makes deputy ministers directly responsible for certain aspects of human resources management, while the Treasury Board of Canada remains the employer. Other amendments further improve reporting to Parliament by the Treasury Board on human resource management issues.

3.12 Part 3 of the PSMA makes significant amendments to the existing *Public Service Employment Act* (PSEA). The intent of these amendments is to modernize staffing by defining merit and providing more flexibility and creating new rules to govern the political activities of public servants. The revised PSEA creates new arrangements for handling internal staffing complaints. The Act encourages the discussion and resolution of employee concerns at the departmental level, as soon as possible. The PSEA creates the Public Service Staffing Tribunal, which will consider and resolve complaints related to lay-offs, revocation, and allegations of abuse of authority. The Tribunal is a new, formal stakeholder in human resources management.

3.13 Part 4 of the PSMA creates the Canada School of Public Service, which intends to integrate and better co-ordinate common training and development activities of the federal public service.

3.14 The nature of many provisions of the various acts is enabling rather than prescriptive. That is, they provide options rather than rules to allow more discretion in managing human resources to meet specific business needs of government departments.

3.15 The Appendix provides a more detailed explanation of the major changes in the legislation.

3.16 Although the *Public Service Modernization Act* was adopted in November 2003, its various legislative components come into force at different times. For example, the Canada School of Public Service was created in April 2004; amendments to the *Public Service Labour Relations Act* and the *Financial Administration Act* take effect in April 2005. These amendments set out the respective responsibilities of the Treasury Board and deputy heads in human resources management. The *Public Service Employment Act* is scheduled to be fully implemented in December 2005.

3.17 An important feature of the new legislative framework is the use of preambles in the PSLRA and the new PSEA. These preambles set out the core values and principles for the management of human resources. The Fryer Report recommended a preamble to outline a set of principles to guide the relationships among the parties, thus limiting the need for prescriptive lists of conditions. Both acts also require a review five years after coming into force.

3.18 The legislative changes are the most extensive since the mid-1960s. In testimony before a parliamentary committee studying the legislation, we said that we considered the legislative proposals to be improvements over the

existing systems and that they would contribute to reforming human resources management.

Other changes were identified to support a new regime

3.19 Over several years, the government identified areas of human resources management that needed improvement but did not require legislative change. It committed to continue working in these areas, which include classification reform, integration of human resources planning with business planning, values and ethics, national areas of selection, and the term employment policy. Exhibit 3.1 provides details of some of these projects.

3.20 The government expected that collectively, the legislative changes and other reforms would simplify human resources management and allow more flexibility. It also expected, as a result, better labour relations and human resources management systems and practices based on values such as merit and non-partisanship.

Organizational changes were announced after the passage of legislation

3.21 On 12 December 2003, the government announced changes that directly affected human resources management. In particular, it created the Public Service Human Resources Management Agency of Canada, reporting to the President of the Privy Council. This was changed by an order-in-council on 20 July 2004; the Agency now reports to the President of the Treasury Board.

Focus of the follow-up

3.22 Our follow-up audit examined the management of the implementation of the new human resources legislation, and assessed the government's progress on its other human resources modernization initiatives. We expected that the new legislation would clarify the roles and responsibilities of central agencies and deputy ministers in human resources management. We also expected that the legislative changes and other modernization initiatives would be supported and managed effectively. We looked for clear plans outlining accountabilities for implementing those other initiatives.

3.23 We recognize that it will take some time to fully implement the new legislative and administrative frameworks. This follow-up sought to assess the government's progress toward establishing a solid foundation for reforming human resources management at an early stage in implementation. Our Office committed to reporting back to Parliament on that progress and we will continue to monitor it. Our follow-up scope and criteria are set out in **About the Follow-Up** at the end of the chapter.

Exhibit 3.1 A sample of non-legislative initiatives underway or completed

Non-legislative initiative	Description and status
Classification reform: Modernizing the standards (Public Service Human Resources Management Agency of Canada [PSHRMAC])	• To modernize, on an ongoing basis, classification standards as a basis for effective staffing and compensation across the public service. • The foreign service officer standard design is complete and is at the collective bargaining stage; draft standards of the economics, statistics and sociology, and border services groups are complete. • PSHRMAC has yet to release its annual update to Parliament on the progress of classification reform.
Compensation policy framework (Treasury Board Secretariat [TBS])	• Framework for determining and implementing negotiated settlements to improve the government's ability to attract and retain employees to the public service. Considers internal and external comparability, individual/group performance, and affordability. • A draft of the policy is complete.
Core learning for employees, managers, and functional specialists (PSHRMAC/Canada School of Public Service)	• Five year project that identifies the core learning needs of employees, management, and functional specialists to work efficiently and to effectively manage the business operations in the public service toward the achievement of results for Canadians. • Library of core knowledge of middle managers is complete; currently piloting core knowledge requirements of middle managers in financial management.
Values and Ethics Code for the Public Service (TBS)	• Code that sets forth the values and ethics of the public service to guide and support public servants in their professional activities. • The Code came into force on 1 September 2003.
Term Employment Policy (TBS/ Public Service Commission [PSC])	• Policy to balance the fair treatment of term employees with the need for operational flexibility. Replaces the Long-term Specified Period Employment Policy and reduces the cumulative working period of term employees to qualify for indeterminate employment from 5 years to 3 years. • The policy came into force between 1 April 2003 and 1 April 2004.
National areas of selection (PSC)	• A plan to expand the use of national areas of selection for jobs open to the general public, thereby removing geographical limits and enhancing Canadians' access to jobs in the federal public service. • National areas of selection for open competitions of senior officer-level jobs were implemented in the fall of 2001. In 2002, a pilot project was conducted for middle and junior officer-level jobs.
e-Recruitment (PSC)	• A plan to adopt modern recruitment technology to expand the use of national areas of selection for jobs in the public service. Modern recruitment technology is required to process a much higher volume of applications received under an expanded area of selection. • Piloted an existing electronic recruitment system in 2002 and launched an interim in-house technology solution (public service resourcing system) in April 2003. • Require long-term funding ($40 million) to implement the plan.
Pre-qualified pools (PSC)	• Delegated the authority to establish pre-qualified pools to four departments on a pilot basis to test possible options that new legislation will open up.

Source: Public Service Human Resources Management Agency of Canada, Public Service Commission, and Treasury Board Secretariat

Observations and Recommendations

Positive legislative changes

3.24 In our April 2000 Report, Chapter 9, Streamlining the Human Resources Management Regime: A Study of Changing Roles and Responsibilities, we found that the roles and responsibilities for managing the government's human resources were fragmented. In particular, we noted that the respective roles of central agencies and deputy heads in this vital area needed to be clarified. The new *Public Service Modernization Act* (PSMA) contributes significantly to that clarification.

3.25 The PSMA essentially consolidated and re-assigned a number of human resource management functions (Exhibit 3.2).

Treasury Board's role as employer was consolidated

3.26 The new PSMA clarifies and reinforces the Treasury Board of Canada's role, as employer, in developing policies and monitoring and overseeing all key aspects of human resources management except for staffing. As the government's general manager, the Treasury Board Secretariat of Canada was expected to guide the implementation of the changes.

3.27 The Treasury Board retained many of its powers, particularly in the areas of labour relations and collective bargaining, pensions and benefits, employment policies, human resource requirements, classification of positions and rates of pay. It also retained its powers to establish qualifications for professional development programs and to make regulations on deployments and appointments to level. The Board will have full responsibility for planning for the human resource needs of the public service (a function that had been split between the Public Service Commission and the Board).

Appointment to level—An appointment based on an employee's ability to function at a certain level rather than the level of the position the employee occupies.

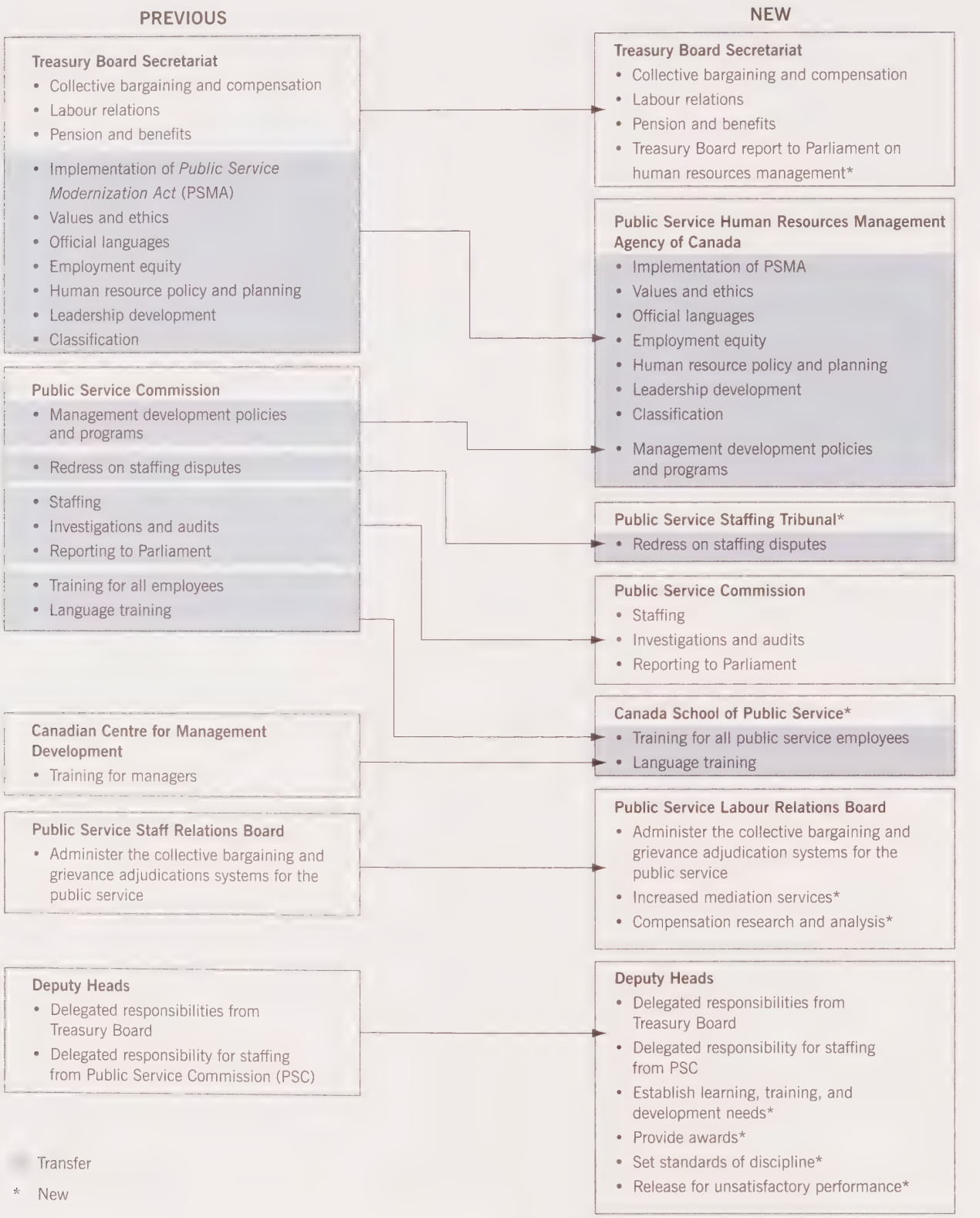
3.28 The revisions to the *Public Service Employment Act* (PSEA) also transfer certain powers to the Board from the Commission. For example, the Treasury Board will be responsible for setting the qualification standards used in the staffing of positions, setting probationary and notice periods, and determining rates of pay on appointment. Finally, as a new requirement, the Board must report on human resource matters that fall under its authority, which increases its oversight role in matters of human resource management.

3.29 Consistent with principles of increased delegation, deputy heads now have some direct powers over human resources management. However, to ensure consistency and accountability across the public service, the Board is still responsible for establishing policies and issuing guidelines on deputy heads' use of their powers and their reporting obligations.

3.30 The intent is an integrated approach to human resources management that clearly defines responsibility and accountability for key functions—an approach that we reported was lacking in 2000.

3.31 We note that although the Treasury Board remains responsible for human resources management under law, some of its functions managed by the Treasury Board Secretariat were moved by the government to the Public Service Human Resources Management Agency of Canada in December 2003. We discuss some concerns with this in paragraphs 3.65 to 3.73.

Exhibit 3.2 Human resources management structure—Transfer and creating responsibilities



The new legislation means the Public Service Commission can focus on its key roles

3.32 In the past, our Office has commented on the many roles played by the Public Service Commission that created a potential for conflict. In earlier studies, the Commission pointed to the potential conflict in finding itself "increasingly present at tables comprising the very officials whose staffing decisions it may be adjudicating, reviewing or auditing."

3.33 Several of the Commission's non-core, operational functions have been transferred to other organizations (Exhibit 3.2). What the Commission retains is sole responsibility for staffing, carrying out investigations and audits, and reporting to Parliament. The new *Public Service Employment Act* (PSEA) proposes that all staffing responsibilities be delegated to deputy heads, except those relating to the political activities of public servants. The Commission is working on a revised delegation and accountability framework that will clearly spell out the responsibilities and accountabilities of deputy heads under the new regime.

3.34 In its key role of protecting the merit principle, the Commission is increasing its oversight activities and rebuilding its audit function through the reallocation of its existing resources. It will need to manage the appeals process for some time after the new PSEA comes into force, because staffing actions begun before that point are to be dealt with under the current system.

3.35 Although many of the Public Service Commission's former operational roles have been shifted to others, it retains some of those responsibilities. For example, it is still responsible for general advertising of positions in the government. The Commission expects to provide some operational assistance to small agencies that lack the resources of larger departments. It will also have to address how to provide services to departments whose delegated authority for staffing has been withdrawn. To address the challenges posed by its ongoing dual role for operations and oversight, it is placing its operational responsibilities in one area as a service agency, headed by a vice-president reporting directly to the president. This arrangement is designed to separate the Commission's service and oversight roles. However, the challenges posed by its dual roles will have to be carefully managed.

The learning function is consolidated

3.36 The *Public Service Modernization Act* created the Canada School of Public Service to provide a single focal point for all training and professional development in the public service. It replaces the Canadian Centre for Management Development and takes over the Public Service Commission's previous roles in training. It also brings a more unified approach to meeting the common learning and development needs of public servants, such as training in financial and human resources and information management, procurement and other professional development areas, orientation to the public service, ethics and values, supervision/leadership/management practices, and language training. As of 20 July 2004, the president of the School reports to the president of the Treasury Board. Given that the Board is responsible for policies on learning, this adds more coherence to training and professional development.

Deputy heads will have more direct responsibility for human resources management

3.37 For the first time, deputy heads' responsibility for human resources management is defined in the revisions to the *Financial Administration Act* (FAA), the PSEA, and the PSLRA. We note that many of the provisions enable rather than prescribe; this will allow departments to move forward with new initiatives as they develop their capacity to take advantage of flexibilities. Many of the provisions allow for a more direct and immediate response to workplace issues, stronger relationships with unions and employees, and earlier resolution or reduction of conflict. Specifically, deputy heads must establish effective union-management committees to deal with immediate concerns, and to set up processes for early dispute resolution. More information on the new roles for deputy heads can be found at www.publiservice.hrma-agrh.gc.ca.

Implementing the reforms

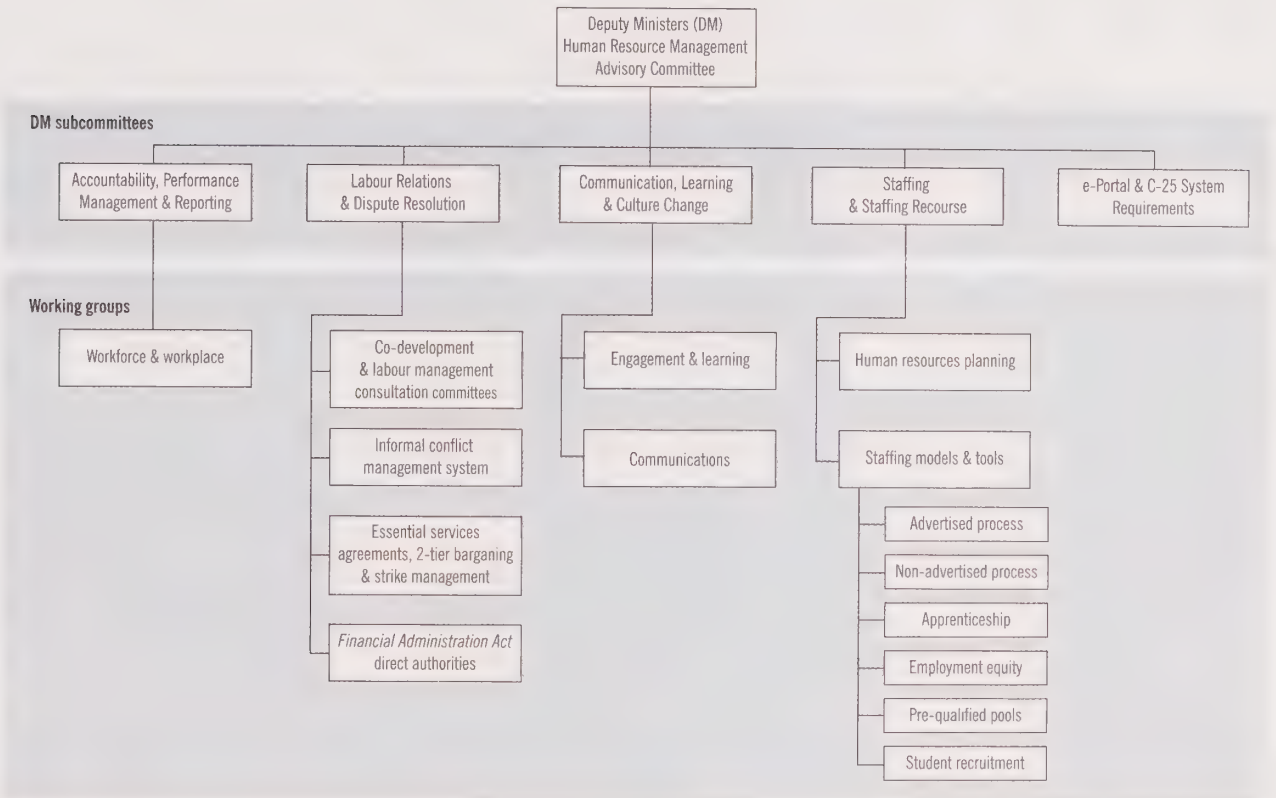
3.38 Along with its recommendations for modernizing human resources management, the Public Accounts Committee said the government had to ensure the clear definition of the roles and accountability for implementing the legislative reforms. To that end, the government set up a committee structure for co-ordinating the many aspects of implementing the PSMA. It also implemented a strong project management structure consistent with the accountability principles that our Office outlined in our 2002 Report, Chapter 9, Modernizing Accountability in the Public Service; it is also consistent with the Treasury Board's policy on project management.

The new management and co-ordination structure is guiding implementation

3.39 In 2003, the Treasury Board Secretariat established the Deputy Ministers Human Resource Management Advisory Committee (known as the MAC). The membership of the Committee and its subcommittees, chaired or co-chaired by deputy heads (Exhibit 3.3), reflects the importance the government has attached to implementing the PSMA and reforming the management of its human resources. The amount of time deputies are investing to support the modernization of human resources management among their many competing demands and priorities reflects their commitment to support the new regime. The MAC has become a permanent subcommittee of COSO, the Committee of senior officials (senior deputy ministers) that provides advice to the Clerk of the Privy Council on the management of the public service.

3.40 The MAC was initially established to oversee the implementation of the PSMA. However, in the spring of 2004, its role was expanded to reviewing all changes in human resources management as many of the non-legislative concerns have an impact on the legislative changes. An example of this interdependency is the linking of human resources planning with business planning. Because the new legislation allows departments to consider future requirements when they hire for existing positions, they need good planning and a sound understanding of human resources they will require in the future. The case study, Human Resource Planning, describes the work being done to improve human resources planning.

Exhibit 3.3 Deputy Ministers Human Resource Management Advisory Committee



Source: Public Service Human Resources Management Agency of Canada

3.41 A committee of assistant deputy ministers mirrors the MAC. Its job is to ensure the horizontal integration of project plans and priorities, identify corporate resources allocated to projects, and monitor challenges and priorities. It acts as the main "traffic controller" for the information flow among committees and the items going forward to the MAC.

3.42 Each subcommittee has a network of working groups that enables line managers, representatives from the regions, and bargaining agents to provide input. The subcommittees provide strategic advice on carrying out the PSMA, while the working groups provide options for implementing policy guidance and the detailed content for practical tools, guidance, and direction needed to support the use of the PSMA in departments. Final approval of any policy remains with the organization responsible for the policy. For example, all policies and issues on staffing require the approval of the Public Service Commission while the policies and issues on labour relations are under the authority of the Treasury Board Secretariat. These measures are significant because they reinforce the accountability of those who are responsible for the policies.

Human resources planning

Human resources planning is now seen as a critical enabler to achieve the full flexibility of the new *Public Service Employment Act.*

The Treasury Board (as employer) is responsible under the *Financial Administration Act* for identifying the current and future needs of the public service, and for establishing basic qualification standards for positions. The new *Public Service Employment Act* enables deputy heads to fill positions based on essential qualifications and considerations for current and future needs at the organizational level. In light of this, the capacity for building a more systematic approach to human resources planning has become a priority.

An interdepartmental human resources planning working group was created in October 2003. Its mandate was twofold: develop a generic planning template that departments and agencies could adapt to their needs and prepare a discussion paper outlining the current state of human resources planning in the public service, improvements needed, and the steps required to rebuild capacity across the public service. The working group has made significant progress on both fronts.

Based on extensive consultation and research, the working group drafted a number of planning tools, including a planning calendar and checklist, tool kit, and guide. These tools are intended to support integrated human resources planning and business planning practices in departments and agencies. In April 2004, the working group also published a discussion paper with several recommendations to help improve the state of planning practices and capacity across the public service. The working group expects to formally roll out the planning tools to departments and agencies in December 2004, and to work on re-building planning capacity and an improved process over the next three to five years.

In addition to the working group, the Public Service Human Resources Management Agency of Canada recently established a planning team and a Centre of Excellence to help support departments and agencies in re-building their human resources planning capacity.

3.43 As they stated in parliamentary hearings on the legislation and subsequently, the unions have significant concerns about what they view as shortcomings in the legislation. Despite this, some unions have seconded some of their staff to work with the government's project management team, and others have participated in working groups and subcommittees. Officials from the Public Service Human Resources Management Agency of Canada and the Public Service Commission have commented on the positive working relationship and useful input that the unions have brought to the process.

3.44 The heads of the Treasury Board Secretariat, the Public Service Human Resources Management Agency of Canada, the Public Service Commission, and the Canada School for Public Service meet informally but regularly to discuss the implementation of the PSMA, other change initiatives, and requirements for additional support. Their collaboration at the top has sent a message to their respective staffs to work together toward the common goal of modernizing human resources management.

3.45 The structure of the MAC with its subcommittees and working groups, the reasonably broad participation of stakeholders, and the meetings of

central agency deputy heads has permitted a collaborative approach to managing implementation activities. Clearly the "tone at the top" is appropriate, with support at the highest levels of management and in the central agencies.

Consistent project management practices have been implemented

3.46 Implementing a new regime for human resources management requires the government to follow sound project management practices. These practices are critical to ensuring the integration of many projects and activities directed toward reform, whether the changes are legislative or non-legislative.

3.47 We found that the basic elements of project management are either present or being addressed. These elements include assessment of risk areas, action plans, schedules and timelines, and performance measures.

3.48 Several committees are involved in project management. For example, the Public Service Human Resources Management Agency of Canada, which is responsible for implementing the *Public Service Modernization Act*, has a project management committee. This committee oversees the approach to project management across all the central agencies involved in implementing pieces of the new legislation or supporting other initiatives. An interdepartmental project management committee has developed a generic project management plan to help departments implement the Act.

3.49 We found mechanisms in place to ensure that the priorities and plans for implementation projects are integrated across the human resource management agencies, and that resources are allocated by priority.

Management of the non-legislative initiatives has improved

3.50 Several non-legislative initiatives (initiatives that do not require legislation) have been under way since 2000. We conducted some preliminary audit work of these initiatives from fall 2002 to February 2003—the results of which caused us concern about their management. Our concerns included a lack of stated priorities, measurable goals, outputs, and outcomes for individual projects. Often, accountability for the projects was not specified, nor were the costs, timelines, and scheduled dates of completion of work. We shared our concerns with central agencies in May 2003 and, to a large extent, they have addressed those concerns.

3.51 We found that work plans were developed to manage many of the non-legislative reform projects under way. The work plans contain information that the individual reform projects lacked initially, including expected outcomes and outputs, accountability for the project, key milestones and expected completion dates, and the resources (human and financial) required to complete the work.

3.52 We also found that in developing the workplans for the non-legislative projects, priorities had been set and links made to legislative projects. For example, the development of a compensation planning framework is a non-legislative initiative that has links to a number of legislative elements. These

include new PSMA requirements for compensation research, labour relations, and establishment of rates of pay on appointment. Links were also made among non-legislative reform projects; for example, classification reform is linked to reforms in areas such as labour relations, compensation, employment equity, and pay equity.

3.53 Together, these improved practices in project management encourage coherence and complementary relationships among the many legislative and non-legislative projects under way to modernize the management of human resources. Projects are not being carried out in isolation from one another.

Tracking costs is essential

3.54 The government has set aside $238 million in additional funding to implement the *Public Service Modernization Act*. At the time of our follow-up audit, about $38 million had been spent on early work and project management; the remaining $200 million will be managed through a strategic investment framework. Under the framework, money provided to departments will be based on the business cases they make to the Treasury Board for access to these funds.

3.55 This process is a good first step to control spending and allocate funding. However, we noted that some stakeholders are concerned about the adequacy of funding. The $238 million set aside will not pay for the total cost of implementing what will likely mean major cultural, organizational, and procedural changes in human resources management. Officials told us that departments will be expected to fund some of these modernization costs by reallocating funds internally. However, given that the government wants more than $12 billion over four years to meet its commitments to health care and other priorities, identifying funds for supporting human resources management changes internally could be a challenge.

3.56 In the past, we have noted problems in identifying and tracking the total amounts spent across government on various initiatives, above and beyond funds allocated specifically for those purposes. All the costs of modernizing human resources management—the legislative and the non-legislative reforms—need to be determined according to the principles of sound financial management and the government's Management Accountability Framework. The total cost will include various "soft" costs that departments must incur in areas such as training, information technology, conflict-management systems, and cultural change.

3.57 We note that the government did not identify and monitor the complete costs of two fairly recent initiatives: implementing a universal classification system and downsizing. We urge the government to track its expenditures on the reform of human resources management carefully. Doing so will make it possible both to assess the adequacy of current funding for implementing the PMSA and to determine the longer-term financial requirements of the reforms.

New dispute resolution agencies face challenges

3.58 A new organization, the Public Service Staffing Tribunal, will resolve staffing complaints. At this writing, no chairperson had been appointed to the Tribunal, although the position was advertised in October 2004, and we were told an appointment could be expected by January 2005. Once the head of the Tribunal is appointed, an organizational structure will have to be established and the organization staffed, and regulations and procedures will need to be developed and communicated to managers, employees, and unions.

3.59 Initially, 18 months was considered the timeframe needed for the tribunal to become operational. If a new head is appointed to the Tribunal in January 2005, under the present plans, the organization will have 11 months to become operational.

3.60 While some work has been done to develop the organizational structure for the Tribunal, we believe the timeframe for establishing the new organization is tight and any delay in appointing the head could jeopardize the date at which the new *Public Service Employment Act* comes into effect.

3.61 The legislation also creates the Public Service Labour Relations Board (PSLRB) for dispute resolution; essentially, a renamed Public Service Staff Relations Board with an expanded mandate and additional responsibilities. This part of the legislation is scheduled to become effective on 1 April 2005.

3.62 Most of the work required for the labour relations board to meet its new mandate has been done (for example, consultation and drafting of regulations, establishment of the new governance structure, preparation for new public interest commissions). But there is still concern about a couple of areas. A key aspect of the Board's new responsibilities is the establishment of a compensation research and analysis function that will provide information to both parties in collective bargaining to help them reach agreement on compensation. This function has not yet moved from conception to operational because of delays in receiving funding for its implementation and delays in creating an advisory board to provide advice to the chairperson on the compensation research and analysis services. Similarly, the PSLRB will be required to expand its existing mediation services considerably, and this aspect of work also needs incremental funding to progress. Funding was approved by the Treasury Board in October 2004, and the Staff Relations Board is taking the necessary steps to establish and enhance those services.

3.63 While the Public Service Staff Relations Board, as an independent quasi-judicial body, has remained separate from the overall management of the implementation of the legislation, we note that it had in place its own planning, project management, and control frameworks, as well as mechanisms for consultation with both employer and bargaining agents to ensure that it would be able to meet the requirements of the new *Public Service Labour Relations Act*.

Prerequisites for continuing success

3.64 In our view, the government has a good foundation for managing the legislative and non-legislative elements of the reform of human resources management. This represents an important change from the way two other such initiatives—PS 2000 and La Relève—were managed. Although much has been accomplished in a relatively short time, we do have some concerns. We believe that the government needs to address them if it is to maintain the present momentum of the reforms and ensure that it can implement them effectively in the coming years.

Human resources management is split

3.65 While the new *Public Service Modernization Act* consolidates the Treasury Board's role as employer, organizational decisions taken after the legislation was passed have split the human resources management functions among many stakeholders. As noted earlier, in December 2003, the government announced the creation of the Public Service Human Resources Management Agency of Canada, a separate organization reporting to the president of the Queen's Privy Council. In July 2004, the new Agency's reporting relationship was changed; it now reports to the president of the Treasury Board.

3.66 The December 2003 announcement indicated the possibility of transferring collective bargaining to Public Works and Government Services Canada after consultation with unions and the current round of negotiations. No further announcement on this point has been made; labour relations and collective bargaining remain the Treasury Board Secretariat's responsibility. Compensation planning, pension and benefits policies, and administration also remain with the Secretariat.

3.67 While the creation of the new Agency, headed by a president at the deputy minister level and focussed on human resources management, indicates more emphasis on the management of people—the government's key, and one of its most expensive, resources—the splitting of roles and responsibilities without compensating co-ordination mechanisms raises some concerns.

3.68 Our 2003 Status Report, Chapter 6, Reform of Classification and Job Evaluation in the Federal Public Service, noted that responsibility for three interrelated key functions—classification, compensation, and labour relations—was divided among three divisions in the Treasury Board Secretariat that worked independently. Because the classification of a job directly affects the salary, the management of these three functions is generally integrated, particularly in response to proposals for changes to a classification plan. In the rounds of negotiation leading to new classification plans, much work is often done to try and reduce the cost of any reforms. We noted in May 2003 that the separation of these three functions was hindering the Secretariat's efforts to reform the classification system. At the time, the Secretariat had recognized that clustering classification, compensation, and labour relations, along with pay equity, would allow for better information sharing and a more integrated approach to these functions.

3.69 We have been told of frequent consultations between the people responsible for collective bargaining in the Secretariat and the classification group at the Agency, but we did not find any formal mechanisms for aligning classification reform with collective bargaining. Given that there were problems when the divisions worked independently within one organization, dividing functions that are normally integrated between two separate organizations creates the potential for more difficulties. In our opinion, strong formal mechanisms for integrating and co-ordinating the efforts of the Secretariat and the Agency will be needed to overcome the effects of splitting human resource responsibilities.

3.70 The Agency retains responsibility for policies for learning and training, and for establishing professional development programs, while the Canada School of Public Service is the key arm for training and learning. Co-ordination between these two organizations will be critical to ensure that policy direction is carried out.

3.71 The Treasury Board is increasing its focus on financial management and implementing the Management Accountability Framework. This framework includes a key people component. Issues of human resources management thus become more complex, given the requirements of co-ordinating, managing, and assigning accountability for programs and activities that are split among different organizations.

3.72 Legislation introduced in Parliament in October 2004 would allow the Treasury Board to delegate to the president of the Public Service Human Resources Management Agency of Canada any powers over human resources management. The legislation also proposed that the president of the Treasury Board play a co-ordination role. In our view, the relationship between the Agency and the Secretariat (operating as the Treasury Board's general manager) needs to be clarified and communicated. Officials we spoke with indicated that they were not clear on the change in roles in the Secretariat and the Agency, where they should go for advice on various human resource issues and how the decision making processes were managed. Without further explanation of how human resource issues will be co-ordinated and managed in an integrated way, our previous concerns about the fragmentation of roles and responsibilities remain.

3.73 **Recommendation.** In carrying out the human resources role of the Treasury Board as the employer, the Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada should clarify how they will formally co-ordinate, integrate, and manage human resource functions and initiatives.

The Secretariat and the Agency's response. As recognized in Exhibit 3.3 and elsewhere in this chapter, a formal governance structure has been established to ensure the horizontal integration of plans and priorities, to identify corporate resources allocated to projects, and to monitor challenges and priorities. In addition to the formal mechanism, co-ordination, integration, and management occur on an informal basis and close working relations exist between the two organizations. The heads of these two

organizations and the President of the Public Service Commission meet regularly to discuss *Public Service Modernization Act* implementation, other change initiatives, and requirements for mutual support. Similarly, at the working levels, frequent consultation occurs between the parts of the organizations involved in, and affected by, human resource management issues; for example, the organizations involved in classification and collective bargaining. Both organizations report to the president of the Treasury Board and constitute part of the Treasury Board portfolio. The secretary of the Treasury Board Secretariat is responsible for providing advice on the coherent policy development and management of his portfolio.

3.74 Under the new *Financial Administration Act*, the Treasury Board must report annually to Parliament on the discharge of its human resource management responsibilities and those of deputy ministers. In the past, we have called for more comprehensive reporting on human resources management.

3.75 However, with the management of these responsibilities split between two organizations (the Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada), it is imperative that these two organizations develop mechanisms to produce an integrated report. In addition, the Public Service Commission is to report on the health of the staffing system.

3.76 Department officials we spoke with expressed concern about possibly having to provide multiple reports to various bodies on different timelines, requiring similar but not identical information. While some preliminary work was done to develop integrated reporting through the Management Accountability Framework, this is an area where more work is needed.

3.77 Another concern is the need to establish meaningful performance measures now and gather benchmark data in order for the Treasury Board and the Public Service Commission to report on whether the new human resources management regime is meeting expectations. This is a critical step, particularly given the mandated five-year legislative review.

3.78 Work on a performance measurement and reporting framework has been started but is not yet complete. A mechanism for integrated reporting that does not unduly burden departments also needs to be established.

3.79 **Recommendation.** The Treasury Board Secretariat and the Public Service Human Resources Management Agency of Canada should produce regular integrated reports on the progress of reforms to human resources management against established performance measures, and these reports should include interim achievements with the ongoing costs of implementation. The Public Service Commission should also establish performance measures and report regularly on progress in implementing the new staffing regime.

The Secretariat and the Agency's response. We agree with the recommendation and work is well under way on the development of a performance measurement and reporting framework for the people

component of the government's overall Management Accountability Framework (MAF). The Deputy Minister Human Resources Management Committee endorsed this component of the MAF on 26 October 2004. It describes the outcomes for sound people management in terms of both the workplace and the workforce. The Public Service Human Resources Management Agency of Canada is now focussing its work on developing the indicators, measures, and data sources that will permit the organization to determine progress on realizing these outcomes.

The Commission's response. The Commission supports the recommendation to establish performance measures and report regularly on progress in implementing the new staffing regime. This will be achieved through the Commission's Staffing Management Accountability Framework, which will set out the requirements, indicators, and measures to evaluate departmental performance in implementing the new regime.

Communications and learning

3.80 The government has recognized that effective communication will be crucial to successfully implementing these reforms. In the fall of 2003, several communication activities coincided with the passage of the new human resources management legislation. While efforts since then have focussed on policy and content development, various efforts have also been made to inform senior executives and departments about the coming changes. For example, the Public Service Commission led a consultative process in June 2004 with line managers and human resource professionals on issues relating to the implementation of the revised *Public Service Employment Act*. In September 2004, the Commission followed this with a conference for over 300 line managers and human resources professionals from across the country concerning various PSEA implementation issues. A further follow-up conference was planned for November 2004. The Public Service Human Resources Management Agency of Canada published a detailed information package on the full PSMA in July, with further elaboration sent out in October. This outlines mandatory requirements under the new acts (PSEA and PSLRA) as well as flexibilities that provide opportunities for doing things differently. The Treasury Board Secretariat planned meetings on changes under the *Public Service Labour Relations Act* for late 2004.

3.81 Although senior management is receiving information, we are concerned that more detailed information may not be circulating at lower levels in departments and, particularly, in the regions. In our view, a prerequisite to implementing the reforms effectively is ensuring that staff throughout departments are properly informed about them. As we were finishing our examination, work began at the Agency on a strategy to engage staff, starting at the assistant deputy minister level. We think much more work is needed to communicate with line managers, human resource professionals, unions, and employees if the PSMA is to be implemented successfully. The Agency indicated that it will intensify its communications in the fall of 2004.

3.82 We note that the Public Service Human Resources Management Agency of Canada, through the work of the various committees, has identified training as a high-risk area that must be carefully managed at all levels. The Agency, in collaboration with the Canada School of Public Service, is working to define the learning needed and is identifying knowledge gaps to develop appropriate, effective content for training programs. A learning strategy has been developed and the new Canada School of Public Service will design the training. This development was still in too early a stage for us to comment on its adequacy, but we recognize that much of the success of the reforms will rest on extensive training and communication.

Developing capacity in departments

3.83 If the government is to successfully modernize its human resource management systems, departments must have the capacity to implement the reforms as planned. This is a key concern that all stakeholders share. Cutbacks in the 1990s in areas such as human resources planning have left skill gaps in this area, now a key underpinning of new initiatives. The demographics of the human resources community indicate that some 47 percent of those professionals are eligible to retire by 2008, compared with 35 percent of the rest of the public service. In a recent report, the Public Service Commission noted possible shortages in the availability of people with the knowledge needed for human resources management at the department level.

3.84 The roles of both human resource professionals and line managers are changing. Human resource professionals will need to assume a role that is more strategic rather than transactional, as we noted in our 2001 Report, Chapter 3, Recruitment for Canada's Future Public Service: Changing the Practices, on recruitment. Line managers will have more responsibility and accountability for human resources. These shifts will be significant for many human resource practitioners and managers.

3.85 The lack of people with the right skills could hinder the government's efforts to translate the provisions of the PSMA into concrete reforms. We note the concern among all stakeholders that a lack of capacity could lead departments to revert to their old systems, stalling progress toward modernized human resources management.

3.86 One of the many implementation projects we noted involves developing criteria for assessing an organization's readiness for certain human resource management activities. The criteria need to be developed further, although the work to date is a reasonable first step toward measuring capacity to implement such reforms.

The need for sustained momentum

3.87 The government's priorities are continually evolving. Reforming human resources management is only one priority among many with which this initiative must compete. We believe it is essential to maintain momentum and ensure that modernization of human resources management remains a priority and an important element in the government's larger agenda. Only then will it be possible to institute reforms and embed them in the operations of government.

3.88 That this initiative will require a big cultural change makes it a particular challenge, one that will need sustained attention over more than five years. In the past, the government has had mixed success at maintaining a focus on long-term projects and keeping them a priority. We note also that many other change initiatives were launched at the same time, and the government is looking to reallocate its budget significantly.

3.89 Officials told us that the MAC would continue to exist after the legislation comes into force. However, it is not clear what other committee structure or mechanisms, if any, will be needed once that happens or what course corrections will be needed as implementation proceeds. Senior officials recognize that work is needed in this area.

Conclusion

3.90 We have described the many positive steps to manage both the implementation of new legislation and the supporting non-legislative initiatives the government has taken since our last Report in 2000 on reforming human resources management. One of the most important is the foundation it has put in place for managing this complex undertaking. We found leadership and a sense of purpose present. With some exceptions, the approach is integrated and emphasizes co-operation and co-ordination. We also note that the committees and working groups involved in implementing the *Public Service Modernization Act* and other reform initiatives have both identified the key risks and challenges to reforming human resources management and developed strategies for dealing with them.

3.91 Despite these efforts, the government will have to monitor progress constantly and be agile enough to make any changes needed to maintain steady progress. In our view, the government must maintain the momentum that has already been established to prevent the growth of cynicism in the public service and ensure that the reforms are implemented successfully.

3.92 We have recommended annual progress reports on reforms. Consideration of these reports by a parliamentary committee would be important as a means of influencing the nature, direction, and pace of change: an opportunity for Parliament to ensure that momentum is maintained and that change is real rather than illusory—and that Canadians are benefiting.

About the Follow-Up

Objective

We examined the management of implementation of the new legislation and continued our assessment of the progress on non-legislated modernization initiatives for human resources management.

Scope

Following our tabling of our April 2000 Report, Chapter 9, Streamlining the Human Resource Management Regime: A Study of Changing Roles and Responsibilities, the government initiated several projects to modernize human resources management. This included the tabling of Bill C-25, the *Public Service Modernization Act*, and numerous non-legislative initiatives.

We examined the management and support provided for implementation of the new legislation. We also updated our work on how the non-legislated modernization initiatives contribute to the stated strategic objectives for human resources management and how they are being managed, co-ordinated, and integrated with legislative changes. We looked, for example, at the objectives of these initiatives, the rationale supporting them, their status and priority, the resources required, their timetable, and other costs, as appropriate. We also looked at the government's capacity to move on a number of fronts, to select priorities, and to assign resources to make the necessary organizational adjustments.

Our work consisted of interviews and reviews of documentation mostly in the Privy Council Office, the Treasury Board Secretariat, the Public Service Commission, the Canada School of Public Service, the Public Service Human Resources Management Agency of Canada, and the Public Service Staff Relations Board.

Criteria

Criteria for this component of the follow-up were drawn from several sources, including past Office of the Auditor General reports and studies, particularly Chapter 9 of the April 2000 Report.

Our criteria consisted of the following:

- The roles and responsibilities of central agencies and deputy ministers for managing human resources are clarified by the new legislation.
- The implementation of the new legislation is supported and managed effectively.
- Clear plans and accountabilities are in place to ensure the achievement of non-legislative modernization initiatives that support a streamlined and simplified human resources management regime.

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Appendix Excerpt from the *Public Service Modernization Act*

Summary

Part 1 enacts the *Public Service Labour Relations Act* to provide for a labour relations regime in the public service which is based on greater cooperation and consultation between the employer and bargaining agents, notably by requiring labour-management consultation committees, enabling co-development, enhancing conciliation and providing for negotiated essential services agreements. This new Act eliminates certain managerial and confidential exclusions and brings unfair labour practices up-to-date. It provides for the establishment of conflict management capacity within departments and more comprehensive grievance provisions. It also establishes the Public Service Labour Relations Board whose mandate is to provide adjudication services, mediation services and compensation analysis and research services.

Part 2 amends the *Financial Administration Act* to put direct responsibility for certain aspects of human resources management in the hands of deputy heads, subject to policies and directives of the Treasury Board. New deputy head responsibilities include determining learning and developmental requirements, providing awards and setting standards of discipline. Part 2 also amends that Act to provide for annual reporting to Parliament by the President of the Treasury Board on the application of the human resources management provisions of the Act.

Division 1 of Part 3 enacts a new *Public Service Employment Act* to modernize staffing in the public service while retaining the core values of merit, excellence, non-partisanship, representativeness and the ability to serve members of the public with integrity in the official language of their choice. The Act gives a new meaning to merit and creates new arrangements for staffing recourse, one of the features of which is the Public Service Staffing Tribunal. The Public Service Commission will continue to conduct investigations and audits on matters within its jurisdiction. The Act establishes, in addition to the annual reporting by the Public Service Commission, a requirement for the President of the Treasury Board to report annually to Parliament on the Treasury Board's responsibilities under the Act.

Division 2 of Part 3 amends the existing *Public Service Employment Act* to permit certain elements of the new Act to come into force sooner. The amendments establish a new Public Service Commission to administer the existing Act and to prepare the regulatory and policy framework for the new Act. They also establish a new Public Service Staffing Tribunal to prepare for the coming into force of the new Act and establish a new regime governing the political activities of public servants in a manner that balances their right to engage in those activities while maintaining the principle of political impartiality in the public service.

Part 4 amends the *Canadian Centre for Management Development Act*, which becomes the *Canada School of Public Service Act*. The School becomes responsible for learning and development activities for employees in the public service.

Chapter

4

Accountability of Foundations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Accountability of Foundations

Main Points

4.1 Despite a number of improvements to the framework for the accountability of foundations to Parliament, overall progress is unsatisfactory. Important gaps remain in the external audit regime and in ministerial oversight, two of the three areas examined in this audit. There is no provision for performance audits of foundations that are reported to Parliament. Nor do mechanisms for ministerial oversight adequately provide for the government to make adjustments in foundations where circumstances have changed considerably.

4.2 Improvements have been made in reporting to Parliament and the public, the third area examined in this audit. The government is committed to better reporting in foundations' corporate plans and summaries and their annual reports, and in the Estimates reports of sponsoring departments. However, performance information remains insufficient for parliamentary scrutiny and needs improvement.

4.3 There are inconsistencies in the governance regime for foundations. The independence of foundations still poses risks for reporting and ministerial oversight, and the application of the transfer payment and alternative service delivery policies is unclear.

Background and other observations

4.4 In 1997, the government introduced a new approach to achieving policy objectives by transferring public funds to foundations—non-profit corporations considered to be at arm's length from the government. In our sample, three foundations were established by direct legislation and the others were established under provisions such as the *Canada Corporations Act*. At 31 March 2004, more than $9 billion in grants had been paid to foundations.

4.5 In the Auditor General's observations on the government's summary financial statements in the Public Accounts of Canada, we have raised concerns about the governance and the accountability of and accounting for government transfers to foundations. These are up-front payments made many years in advance of need. Our performance audits in 1999 and 2002 found that accountability to Parliament was placed unnecessarily at risk—the government had failed to meet the essential requirements for accountability to Parliament, namely credible reporting of results, effective ministerial oversight, and adequate provision for external audit.

4.6 In Budget Plan 2003, the government announced improvements in the accountability of foundations, commitments that it repeated in Budget Plan 2004. In this follow-up audit, we examined the progress it had made.

4.7 This chapter does not express a view on the merits of foundations as a vehicle to achieve the government's policy objectives. Our findings should not be interpreted in any way as a criticism of the individuals in charge of the foundations.

The government has responded. The Treasury Board of Canada Secretariat's response, on behalf of the government, disagreed with our conclusion that overall progress has been unsatisfactory and with our recommendation that the Auditor General, with a few exceptions, be appointed as external auditor of foundations. The government recognized the need for further improvement in a number of areas and expressed a willingness to explore the areas of disagreement to see if solutions that respect the independence of foundations and overall policy objectives can be identified.

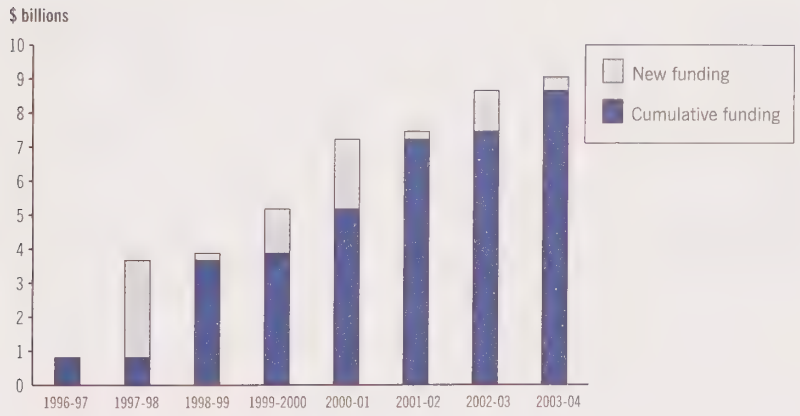
Introduction

4.8 In Budget Plan 2003 (Appendix A), the government referred to foundations as a new approach to meeting the needs of Canadians:

> Foundations use up-front endowment funding and independent arm's-length boards of directors made up of experienced and knowledgeable individuals ... foundations have become important tools for implementing policy...

4.9 From 1996–97 to 2003–04, the government transferred more than $9 billion to foundations—$1.2 billion in 2002–03 alone and $400 million in 2003–04 (Exhibits 4.1 and 4.2). These are up-front payments made many years in advance of need. With transfers of this magnitude, concerns about the accountability of foundations have grown. This audit examined 6 sponsoring departments in relation to 11 foundations (Appendix B).

Exhibit 4.1 Transfers to foundations



Source: Public Accounts of Canada

4.10 Accounting for transfers to foundations and accountability are long-standing issues. Our Office first raised concerns in 1997. Since then, both we and the Standing Committee on Public Accounts have made recommendations to the government, and Parliament has shown a growing interest in these issues (Exhibit 4.3).

4.11 The Budget plans 2003 and 2004 contained commitments to improve the accountability of foundations. The government noted that the improvements are to be implemented on a "going forward" basis—that is, they are to be implemented for new foundations or through amended funding agreements for existing ones. The government stated that it would consult with foundations to explore the incorporation of its new commitments in existing funding agreements.

Exhibit 4.2 Summary financial information on foundations, 1996–97 to 2003–04

Foundation[1]	Year announced	Funding received[2]	Grants provided[3]	Interest earned	Administration	Balance 31 March 2004[4]	Funding commitments signed[5]
	($ millions)						
Canada Foundation for Innovation	1997	3,651	1,230	740	39	3,122	1,529
Canada Millennium Scholarship Foundation[6]	1998	2,500	1,155	690	47	1,988	9
Canada Health Infoway Inc.	2001	1,200	51	83	30	1,202	42
Endowment Funds[7]	Between 2000 and 2002	389	10	48	11	416	104
Genome Canada	2000	375	188	52	19	220	198
Aboriginal Healing Foundation	1998	350	241	86	43	152	139
Sustainable Development Technology Canada	2001	350	6	10	7	347	37
Canadian Health Services Research Foundation	1997	152	37	14	7	122	21
Other foundations under $125 million[8]	Between 2000 and 2002	120	36	13	4	93	16
Total		**9,087**	**2,954**	**1,736**	**207**	**7,662**[9]	**2,095**

1 The foundations reflected in this table have each received over $10 million in total funding from the government since 1997, specifically for spending in a future year more than a year ahead.

2 Transfers include $100 million announced in the March 2004 Budget that were receivable by the foundations at 31 March 2004.

3 In addition to grants, this column includes eligible project expenses.

4 These balances are at the date of the latest annual reports, where 31 March 2004 financial statements are not yet available—modified to include the $100 million announced in the March 2004 Budget.

5 Figures are based on representations from foundations, where not disclosed in their financial statements.

6 The $9 million reported is related only to the excellence awards. As at 31 December 2003, the Foundation was committed to pay bursaries of approximately $250 million during 2004.

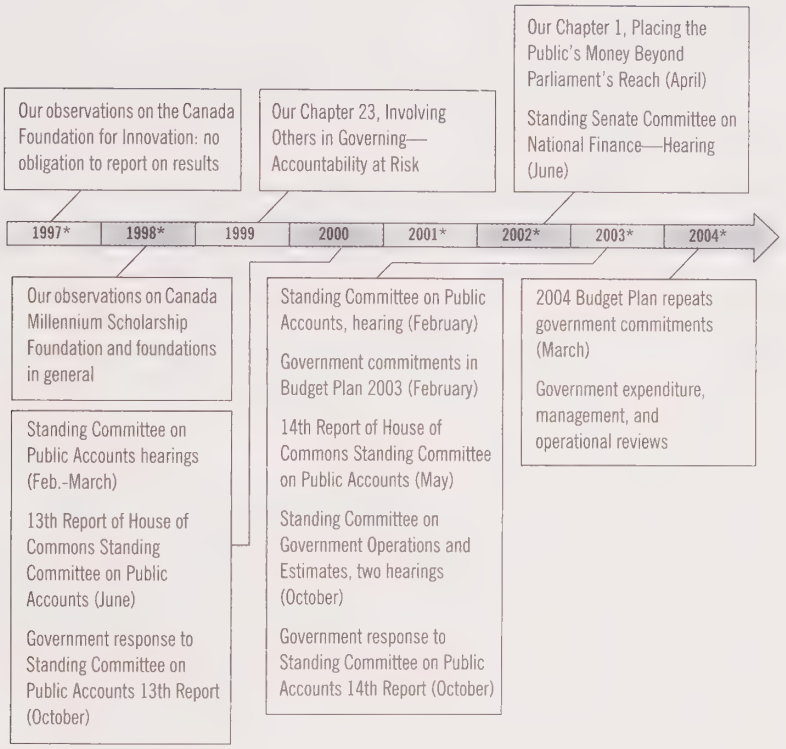
7 For endowment funds, only the earnings are disbursed: these include Green Municipal Investment Fund; Pierre Elliott Trudeau Foundation; Clayoquot Biosphere Trust Society; Pacific Salmon Endowment Fund Society; Canadian Institute for Research on Linguistic Minorities, University of Moncton; and Frontier College Learning Foundation.

8 These are Foundation for Climate and Atmospheric Sciences and Forum of Federations.

9 In addition to funding for foundations and endowments, $550 million had been transferred to other organizations at arm's length from the government, $391 million of the transferred amount had yet to be used at 31 March 2004. These organizations are Canadian Institute for Health Information; Green Municipal Enabling Fund; Precarn; Canadian Network for Advancement of Research, Industry and Education; Canadian Institute for Advanced Research and Canadian Centre for Learning.

Source: Adapted from Public Accounts of Canada 2004

Exhibit 4.3 Concerns about foundations have grown



* Our observations on the Financial Statements of the Government of Canada: accounting for transfers and accountability of foundations in the Public Accounts of Canada

4.12 In 2004 the Treasury Board Secretariat of Canada asked the Auditor General for input to its management and operational reviews, including the review of governance in Crown corporations and other government institutions. We reinforced our concerns about the lack of a comprehensive governance and accountability framework for foundations and encouraged the government to develop an appropriate regime—for example, by considering the findings in our April 2002 Report.

Accounting issues

4.13 Since 1997–98, the Auditor General's observations on the government's summary financial statements in the Public Accounts of Canada have raised concerns about how the government accounts for transfers to foundations.

4.14 The government has recorded these payments as expenses, even though the foundations do not expect to use the funds for many years. At 31 March 2004, nearly $7.7 billion of these funds were still in the foundations' bank accounts and investments, earning interest. This accounting treatment has resulted in a reduction of the reported annual surplus when funds are transferred to foundations, rather than when funds

are distributed to the ultimate intended recipients or used for the ultimate purposes that the government announced for this spending.

4.15 While we have questioned the government's accounting for these transfers, we cannot state unequivocally that the government's method of accounting for foundations contravenes the accounting standards established by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants. We have therefore continued to issue unqualified opinions on the government's summary financial statements, while raising this as an "Other Matter" in the Report of the Auditor General on the financial statements of the Government of Canada.

4.16 To resolve this outstanding disagreement, we have looked to developments in accounting standards; specifically, we have been following the progress of two relevant PSAB projects.

4.17 The accounting standard recently issued by the PSAB for implementation in 2005–06 provides guidance on determining whether an organization is controlled by the government. If the foundations were deemed to be controlled by the government pursuant to this new standard, then payments to them could not be recorded as expenses, since the foundations would then be considered to be within the government reporting entity. We are currently discussing the implications of this PSAB standard with officials of the Treasury Board Secretariat.

4.18 We are also continuing to monitor progress on a second PSAB project, which seeks to revise guidance on accounting for government transfer payments, including multi-year funding.

4.19 The Auditor General's observations on the government's financial statements in the 2003–04 Public Accounts of Canada have noted the link between accounting issues and the need to improve accountability:

> The accountability and governance structures for the foundations may be influenced by the desire to ensure that transfers to foundations can be treated as expenses immediately, rather than when these funds are used by the foundations for their ultimate purposes. In my view, decisions on funding and accountability should be based on the need for sound management of public funds; they should not be based on the goal of achieving a desired accounting result.

Focus of the follow-up

4.20 Our audit examined selected departments that sponsor foundations (Exhibit 4.4), including their action on the government's commitments and our previous recommendations in three areas: reporting to Parliament and the public, ministerial oversight, and provision for external audit and evaluation. Our objectives were to assess the extent to which the government, central agencies, and sponsoring departments have acted to

improve the accountability of government-sponsored foundations to Parliament and the implications for the accountability framework presented in Chapter 1 of our April 2002 Report (Appendix C).

4.21 We looked for improvements in accountability in a number of areas, including the extent to which the government's Budget commitments adequately addressed our recommendations and those of the Standing Committee on Public Accounts; whether provisions were introduced with respect to these recommendations; and, where provisions exist, what actions had been taken.

4.22 On 15 November 2004, the government tabled Bill C-21, with the objective of modernizing the governance framework for federal not-for-profit corporations. Several of the foundations that are mentioned in this audit will be subject to the new regime. However, the amendments proposed by this bill

Exhibit 4.4 Sponsoring departments selected for audit, and government funding to foundations

Sponsoring departments and foundations	Previous Auditor General reports	Total funding 31 March 2004 ($ millions)
Natural Resources Canada and Environment Canada		
Sustainable Development Technology Canada	2002	350
Green Municipal Investment Fund*	2002	200
Green Municipal Enabling Fund*	2002	50
Industry Canada		
Genome Canada	2002	375
Canada Foundation for Innovation	1999 & 2002	3,651
Pierre Elliott Trudeau Foundation	Not applicable	125
Canadian Institute for Advanced Research	Not applicable	25
Health Canada		
Canada Health Infoway Inc.	2002	1,200
Canadian Health Services Research Foundation	1999 & 2002	152
Human Resources and Skills Development Canada		
Canada Millennium Scholarship Foundation	1999 & 2002	2,500
Indian and Northern Affairs Canada**		
Aboriginal Healing Foundation	Not applicable	350

* Federation of Canadian Municipalities administers these funds
** The sponsoring department is now Indian Residential Schools Resolution Canada

Source: Public Accounts of Canada 2001–02 to 2003–04 inclusive

do not address our concerns about the lack of performance audits and an appropriate mechanism for ministerial oversight.

4.23 More details on the audit objectives, scope, approach, and criteria are found in **About the Follow-Up** at the end of the chapter.

Observations and Recommendations

4.24 In our 2002 audit, we noted that both foundations and granting councils (for example, the Natural Sciences and Engineering Research Council of Canada) redistribute public money for a variety of purposes, at arm's-length from the government. Unlike the granting councils, foundations are not answerable to Parliament through a minister. The government achieves public policy objectives through foundations. However, the foundations are independent corporations in law, which, in our view, raises the question of how the government can be held to account for the transferred funds.

Reporting to Parliament and the public

Provisions for corporate plans and annual reports have improved

4.25 All the foundations in our sample, except for the Aboriginal Healing Foundation and the Canada Millennium Scholarship Foundation, are now required by their funding agreements to provide corporate plans each year to sponsoring ministers. With respect to ministers tabling corporate plans or summaries in Parliament, only the Canada Foundation for Innovation (CFI) has such a provision. However, the CFI corporate plan summary was tabled by the minister in Parliament as part of the CFI annual report. In our view, corporate plans or summaries should be tabled separately to allow timely consideration.

4.26 In 2003 all the foundations in our sample submitted their annual reports to sponsoring ministers and made them public. However, only five of these annual reports were tabled in Parliament by sponsoring ministers, including the three foundations that are required to do so by legislation (Canada Millennium Scholarship Foundation, Canada Foundation for Innovation, and Sustainable Development Technology Canada).

Performance information can be improved

4.27 We examined the information in the corporate plans and annual reports of the foundations included in our audit. Most foundations provided information on how much money was spent and how many projects were funded. Improvements are needed, however, with respect to information on the results achieved by the foundations.

4.28 Some efforts are underway to improve performance reporting, including the following:

- The Treasury Board Secretariat is developing a government-wide framework for reporting on federally supported climate change activities

and has invited the Green Municipal Funds and Sustainable Development Technology Canada to participate.

- The Green Municipal Funds introduced a set of performance indicators in their *2003–2004 Annual Statement of Plans and Objectives* and a Project Performance Reporting System that required all project applicants to quantify their environmental results in a consistent reporting framework.

Further efforts are needed to improve information on results.

4.29 **Recommendation.** Sponsoring ministers should table in Parliament the corporate plans or summaries and the annual reports of foundations in a timely manner. In consultation with the foundations, the sponsoring departments should encourage them to include meaningful information on results in their plans and reports.

Government's response. We agree with the Auditor General's conclusion that improvements have been made in reporting to Parliament and the public.

In Budget Plan 2003, the government committed to undertaking a number of measures to improve the provision of information to Parliament on the plans and results of foundations. All statutory reporting requirements to Parliament are being met. For many years now, ministers have tabled the annual reports of foundations in Parliament, representing 80 percent of all transfers to foundations. To the extent there are other significant foundations whose reports are not tabled in Parliament, the Treasury Board Secretariat will encourage departments to do so.

In addition, departments are required to report on the significant plans and results of foundations in their reports on plans and priorities and departmental performance reports. They are also required to situate these within the overall plans and results of the department. This horizontal reporting requirement exceeds the expectations of the Auditor General. The Treasury Board Secretariat has issued guidelines on these reporting requirements.

The government believes a considerable amount of information on plans and results is available through these reports tabled in Parliament and the Web sites of both departments and the foundations. Opportunities therefore exist for the engagement of ministers and the foundations. As an example, many foundations have appeared before parliamentary committees.

Nevertheless, the government acknowledges that further improvement in the quality and comprehensiveness of reporting on foundation plans and results can be made, and it undertakes to do so.

Reporting by sponsoring departments

Insufficient information for Parliament

4.30 Additional transfers of funds by government to foundations are often in larger amounts than the initial grant (Exhibit 4.5). This indicates the need for good information in the Estimates documents each year. However, the independence of foundations raises the concern that sponsoring departments may not always be able to obtain the necessary information for Parliament.

4.31 The Treasury Board transfer payment policy, which came into effect in June 2000, requires sponsoring departments to report to Parliament on transfer payments exceeding five million dollars. They must include information such as objectives and expected results in reports on plans and priorities, and evidence of related results achieved in departmental performance reports. Budget Plan 2003 reinforced these requirements, and it added that sponsoring departments are expected to situate the information on foundations in the context of their overall priorities and results, a commitment that went beyond our recommendations in 2002.

Exhibit 4.5 Examples of the flow of government funding to foundations

Foundation	Initial funding	Second payment	Third payment	Fourth payment	Fifth payment
	$ millions (fiscal year of payment)				
Genome Canada	160 (1999–2000)	140 (2000–01)	75 (2002–03)	-	-
Canada Foundation for Innovation	801 (1996–97)	200 (1998–99)	900 (1999–2000)	1,250 (2000–01)	500 (2002–03)
Canada Health Infoway Inc.	500 (2000–01)	600 (2002–03)	100 (2003–04)	-	-

Source: Public Accounts of Canada 2001–02, 2002–03; Budget plans 2003 and 2004

Outcomes were not adequately reported

4.32 Our review of Estimates documents tabled since our last audit (reports on plans and priorities for 2002–03 to 2004–05 and departmental performance reports for 2001–02 to 2003–04) suggests that improved reporting will take more time. We found more information each year on foundations in the Estimates documents of all the sponsoring departments. The information focussed mainly on the foundations' expenditures and activities or on broad objectives that in many cases were not measurable. The outcomes or benefits for Canadians resulting from the billions of dollars transferred to foundations were not adequately reported. One exception was Environment Canada. Although many of the actual results for projects funded by the Green Municipal Funds will not be known for some time, the Department has begun to report estimated figures on the key environmental impacts the projects will achieve.

Need to integrate reporting on results of foundations and sponsoring departments

4.33 We noted that as part of their commitment to undertake independent evaluation, nine foundations in our sample have developed evaluation or results-based management and accountability frameworks. These frameworks have the potential to help the foundations implement results-based management and eventually report on results.

4.34 Foundations often are not the only government-funded entities in a public policy area. For example, when Genome Canada and the Canada Foundation for Innovation were created in Industry Canada's portfolio, Technology Partnerships Canada was already a special operating agency in the Department. All three organizations distribute public funding to improve Canada's innovation performance.

4.35 In their Estimates documents, most sponsoring departments do not show the links between their results and those of foundations where they both deliver in a common public policy area. Such links are needed for sponsoring departments to integrate foundations' expected and actual results with their own overall priorities and results.

4.36 **Recommendation.** Sponsoring departments engaged in public policy areas that involve foundations should, in consultation with foundations, develop frameworks for reporting that link to the way the foundations measure and report results.

Government's response. The horizontal integration of public policy is a key priority of the government. As acknowledged by the Auditor General, considerable effort and progress has been made in developing results-based management and accountability frameworks. Following the commitment made in Budget Plan 2003, some departments now have the ability to undertake evaluations that can assess the horizontal integration of their programs with those of the foundations. Further efforts will be made to undertake these evaluations and to ensure effective integrated reporting on results to Parliament.

External audit and evaluation

Disagreement on performance audit

4.37 The external audit regime for foundations does not include provision for performance audits that are reported to Parliament. The government has not made a commitment in this regard. In its 14th Report, the Standing Committee on Public Accounts recommended that for those foundations either created through legislation or receiving significant federal funding (at least $500 million), the federal government

- seek amendments to the funding agreements to provide for periodic program evaluation, value-for-money audits, and independent assessment of the fairness and reliability of the performance information…; and
- appoint the Auditor General of Canada as external auditor of these foundations.

The government disagreed with these recommendations and, by implication, our similar recommendation.

4.38 The government responded:

> Requiring foundations to accept the public sector-type standards and operations as well as establishing the Auditor General of Canada as their auditor…could undermine the independence of the foundations, reduce their operational flexibility and organizational effectiveness and thereby reduce their usefulness in achieving the government's policy objectives… It is the responsibility of foundation members to appoint their external auditor and [the authority] to whom the external auditor reports. It should be left to foundations to determine whether to establish such measures as value-for-money audit, independent assessments of the "fairness" of the information presented in reports, or the selection of the Auditor General of Canada as their auditor.

4.39 In Budget Plan 2003, the government stated that foundations will be subject to independent evaluations, comprehensive performance reporting, and compliance audits of the use of federal funding and that these would cover most of the expectations relating to value-for-money (now performance) audits.

4.40 The government has transferred billions of dollars to foundations to achieve its policy objectives. In receiving these up-front transfers, foundations are effectively exempted from the kind of periodic scrutiny by Parliament that occurs when funds are appropriated annually. Once taxpayers' money is transferred to a foundation, the government relies on the foundation's directors and members to achieve public policy objectives.

4.41 Given the magnitude of these transfers, the public policy purposes involved, and the reduced opportunities for parliamentary scrutiny, the existing provisions for audit and evaluation in funding agreements with foundations are not adequate. In our view, performance audit is needed to provide Parliament with information and assurance on due regard for economy and efficiency; on procedures to measure and report on effectiveness, environmental effects, propriety, compliance with authorities, and adequacy of internal controls; and on verification of performance information. The Auditor General is well placed to conduct this work. However, where foundations involve provincial or territorial governments, or where the federal government is not a major contributor, other audit arrangements may be more appropriate.

4.42 In October 2003, the Standing Committee on Government Operations and Estimates, whose mandate includes the review of foundations, held hearings at which government officials, the Auditor General, and the heads of a number of foundations appeared as witnesses. A member of the committee asked foundation officers what problems would be caused if a foundation were subject to audit by the Auditor General, access to information law, and reporting to Parliament through a minister. Committee

members agreed that foundations should respond in writing to these questions. We would welcome such responses to the Standing Committee on Government Operations and Estimates.

4.43 **Recommendation.** The federal government should ensure that foundations are subject to performance audits that are reported to Parliament. The Auditor General should be appointed as the external auditor of foundations, with a few exceptions.

Government's response. The government believes that the current framework, including the independent audit of the foundations' financial statements, compliance audit, independent evaluation, and comprehensive performance reporting in annual reports, already addresses most of the expectations relating to performance (value-for-money) audit. Nevertheless, the government will undertake to encourage foundations to implement performance audit regimes where appropriate.

It may be possible, with the agreement of foundations, for performance audits to be undertaken as an extension to the scope of the compliance audit provisions of existing agreements. Such audits could be undertaken by the external auditors or internal auditors, or, at the discretion of the relevant minister, a request may be made to the Auditor General to perform this work. Professional standards, such as those of the Canadian Institute of Chartered Accountants, exist to guide such audits.

It should also be noted that the framework that exists is similar to that for many other federal transfer payments to other governments, not-for-profit organizations, and businesses. As with these programs, the Auditor General has similar abilities to undertake performance audits and report these to Parliament.

With respect to the appointment of their external auditor, the government believes that the independence of these not-for-profit organizations and the requirements of their incorporation demand that this decision be left to the membership. Existing legislation and assurance auditing standards require the appointment of professionally accredited auditors. These provide assurance to all stakeholders as to the integrity and the reliability of the financial statements of these organizations.

The government believes that it is generally appropriate for the Auditor General, as Parliament's auditor, to be the auditor of most, if not all, federal government entities. Foundations are independent from and external to the federal government. As such, it believes the appointment of their external auditor should remain a fundamental right of the membership of these organizations, as it is for all private not-for-profit sector organizations. It should also be noted that it is not necessary to be appointed external auditor of an organization in order to have the ability to undertake an audit of the use of federal funding.

Need for evaluation standards

4.44 The foundations set their own terms of reference for evaluations required by funding agreements. In our view, consistent application of evaluation standards is needed to assess whether foundations have met the major government objectives set for them. Departments follow the standards set out in the Treasury Board's evaluation policy. Comparable standards could be used by foundations. This is a new element in our accountability framework for foundations (Appendix C).

4.45 We did not examine the evaluations or related documents commissioned by foundations but did find some good practices; for example, some foundations have asked officials in sponsoring departments to comment on evaluation documents such as draft terms of reference.

4.46 **Recommendation.** In new or amended funding agreements, sponsoring departments should seek to ensure that evaluations commissioned by foundations meet recognized evaluation standards.

Government's response. The government agrees that foundations should use recognized evaluations standards. However, it is very important to note that the Auditor General did not examine the evaluations or related documents commissioned by foundations and, as such, is not suggesting that such standards are not being followed. It is also important to note that departments are already obliged to follow the Treasury Board Evaluation Policy in the conduct of their evaluations.

Progress by sponsoring departments and foundations in evaluation

4.47 We found that 10 of the 11 funding agreements between sponsoring departments and foundations in our sample have provisions for independent evaluations. We did not expect evaluation studies to be available for more recently established foundations, such as Sustainable Development Technology Canada. In general, foundations have scheduled dates for evaluation and are meeting them. For example, in May 2003 the Canada Millennium Scholarship Foundation completed the five-year review mandated in its legislation. This report was tabled in Parliament in November 2003. Some foundations have included significant evaluation findings in their annual reports. We noted that the Aboriginal Healing Foundation has voluntarily undertaken three evaluations.

Provisions for compliance audit but little action

4.48 With respect to its commitment for independent compliance audits, the government indicated that these audits could be undertaken by departmental internal auditors, external auditors, or the Auditor General.

4.49 We found that eight funding agreements gave sponsoring ministers the authority to undertake compliance audits, but none was planned or underway at the time of our audit. We also noted that three foundations, the Green Municipal Investment Fund, the Green Municipal Enabling Fund, and the Aboriginal Healing Foundation, had undertaken their own compliance audits and review of the funding agreement. In addition, the Canada Health

Infoway Inc. funding agreement requires an annual compliance audit by an independent third party, and the first of these has been completed.

Financial audit information is being provided

4.50 All the foundations in our sample have provisions for a financial statement and a report by an external auditor who is appointed by the board or members of the foundation. The annual reports of the foundations included audited financial statements, prepared in accordance with Canadian generally accepted accounting principles.

Ministerial oversight

4.51 We expected to see mechanisms that would allow sponsoring departments to make adjustments if foundations did not perform as expected or if circumstances changed considerably. Such oversight typically requires strategic monitoring to gather more information than is contained in annual or other reports. The Budget plans announced commitments to include provisions for ministerial intervention in the event of significant deviation from the funding agreement, and for dispute resolution. These commitments deal with only part of our recommendations on ministerial oversight (Appendix D). There was no commitment by the government to introduce a mechanism to make adjustments in the face of changing circumstances.

Mechanisms are needed to allow positive adjustments

4.52 At present, with some exceptions, the government typically introduces adjustments by amending the existing funding agreement when it provides additional funding to a foundation. For example, when additional funds were provided to Sustainable Development Technology Canada and the Canada Foundation for Innovation, the funding agreements were amended to expand the project eligibility criteria to reflect changes in government policy.

4.53 As we recommended in 2002, an adjustment mechanism is needed to allow sponsoring ministers and their departments to intervene when a foundation is clearly not meeting its purpose or when circumstances in a specific public policy area have changed considerably since its creation. Such a mechanism would ensure that foundations do not work at cross-purposes with sponsoring departments. The adjustment mechanism should not rely on the allocation of additional funding and revisions to the funding agreement.

New provisions for extreme situations

4.54 All the funding agreements in our sample have provisions to deal with extreme situations such as default or the foundation breaking the agreement. The agreements define default (for example, false or misleading representation and information, or any significant failure in performance and/or compliance) and prescribe the procedures for remedies and/or arbitration. All the foundations in our sample also have dispute resolution clauses in their funding agreements.

4.55 Some funding agreements give the government authority to terminate the agreement if defaults are not remedied to the satisfaction of the sponsoring minister. Furthermore, as we recommended in our 2002 Report,

most funding agreements now contain a right for the minister to recover unspent public funds on winding up the foundation.

Some good practices in strategic monitoring

4.56 Departmental officials have attended board meetings of some foundations as observers and have established procedures to obtain and comment on information and documents presented to boards. There are also arrangements for departmental officials to sit on foundations' advisory boards, audit and evaluation committees, and other governance bodies.

4.57 Industry Canada officials told us that in addition to attending such meetings, they have regular contact and consultations with, for example, the Canada Foundation for Innovation and Genome Canada. They stated that this approach lets them play an effective role in strategic monitoring and the prevention of disputes. We also noted examples of good practices with the Green Municipal Funds and Sustainable Development Technology Canada (Exhibit 4.6).

Exhibit 4.6 A good practice in strategic monitoring

The Green Municipal Funds (Green Municipal Enabling Fund and Green Municipal Investment Fund) are administered by the Federation of Canadian Municipalities (FCM) and, as such, are unique in our sample.

The Funds are co-sponsored by Environment Canada and Natural Resources Canada. Although the FCM's National Board of Directors is the formal and final authoritative body governing the Funds, the Board is advised by the 15 member Green Municipal Fund Council. Five of the council members are federal employees: currently, two are from each sponsoring department and one from Transport Canada. They act as a unified voice for the federal government, are briefed on the government's position on specific issues, and can intervene to influence decisions if necessary.

The federal members of the council also have an opportunity to review and comment on draft documents, such as the corporate plan and the annual report, prior to their publication. They also receive quarterly updates on the Funds' performance indicators, information that is then provided to federal departments.

The procedures have been formalized in a memorandum of understanding between the two sponsoring departments.

Central agency roles

4.58 We expected leadership from central agencies, in working with sponsoring departments, to improve the accountability framework for foundations and to implement Budget plan commitments.

4.59 In our 2002 Report, we recommended that the Privy Council Office (PCO) ensure that legislation to establish foundations met the essential requirements for good governance and accountability to Parliament, and that departments had fully defined the roles and responsibilities of federal appointees to foundation boards. The PCO did not indicate that it planned to take any action in response to our recommendations directed to it.

4.60 Although we did not make any recommendations to Finance Canada, our 2002 audit recognized the Department's role in the Budget process with

respect to the levels of funding provided to foundations. Finance Canada elaborated on this role but referred most of our questions about the Budget plan commitments to the Treasury Board Secretariat.

The Treasury Board Secretariat needs to clarify the policy framework for foundations

4.61 **Policy on transfer payments.** We recommended that the Treasury Board Secretariat review the use of exemptions to the transfer payments policy that allow payments to be made to foundations in advance of need; it has planned no such review. We believe that paying more than $9 billion in advance of need could limit the flexibility of future parliaments and governments to respond to changing circumstances and priorities.

4.62 The transfer payment policy does not define "conditional grant," the type of transfer payment used for foundations. Treasury Board Secretariat officials informed us that the specific policy on conditional grants is under development and may be included in the revised policy on transfer payments. The officials also indicated that the policy direction for sponsoring departments was provided in Budget Plan 2003, in remarks by Secretariat officials before parliamentary committees, in guidance to departments, and in their publications.

4.63 **Policy on alternative service delivery.** The Budget plans state that the policy principles (Appendix A) are consistent with the alternative service delivery (ASD) policy that took effect in April 2002. Treasury Board Secretariat officials told us that this policy applies to departmental ASD initiatives including foundations that are classified as shared governance corporations. Our sample includes six such foundations. Since the ASD policy came into effect, a new foundation also classified as a shared governance corporation was funded by the federal government. However, Secretariat officials informed us that the ASD policy did not apply in this instance because the new foundation was incorporated under the *Canada Corporations Act*, by parties outside the government. The application of the ASD policy with respect to foundations is not clear.

4.64 The ASD policy requires departments to prepare a case analysis as part of the approval process for new initiatives, with some exceptions. The analysis must address key policy considerations that reflect the public interest, including questions on governance, results to be achieved, service delivery, and values and ethics. However, some sponsoring departments informed us that they had first learned of the amount to be paid to foundations only when federal budgets were announced. In our view, case analyses or their equivalent are needed to ensure that the amount and timing of the payments are fully justified prior to funding announcements.

4.65 The ASD policy does not require case analyses for additional payments to existing foundations. However, Treasury Board Secretariat officials told us that departments are required to make their case in submissions to the Treasury Board for funding to foundations, including increases to existing ones following public announcements.

4.66 **Recommendation.** The Treasury Board Secretariat should clarify the application of the policy on alternative service delivery with respect to foundations and include a requirement for case analyses (or equivalent) prior to announcements of funding for new or existing foundations.

Government's response. The Policy on Alternative Service Delivery, effective 1 April 2002, applies to the government organizations named in Schedules I, I.1, and II of the *Financial Administration Act* when seeking to create new organizations structured as shared governance corporations. Several foundations meet the policy criteria; however, they were created prior to the policy coming into force. The policy cannot be applied retroactively; however, should these foundations be considered for restructuring in the future, the policy would then apply in that instance. The policy does not apply to third parties that create foundations.

It is important to distinguish between organizational form decisions and funding decisions. The purpose of the Policy on Alternative Service Delivery is to ensure that the choice of organizational form is in the public interest. Funding decisions do not fall under the Policy. However, many of the same principles found in the Policy apply to the funding of organizations, such as foundations, through transfer payments. For example, the decision to fund the one foundation privately created after the Policy on Alternative Service Delivery came into effect in 2002 was made after a case analysis was completed. The transfer payment funding proposal was then approved by the Treasury Board. The Policy on Transfer Payments is currently under review, and the requirement for a case analysis prior to funding will be considered for inclusion.

4.67 **Federal appointees.** As noted earlier, six foundations in our sample are shared governance corporations—corporate entities to whose governing bodies Canada has a right to appoint or nominate one or more members. The President of the Treasury Board's *2003 Annual Report to Parliament, Crown Corporations, and Other Corporate Interests of Canada* shows the proportion of board members of shared governance corporations who are federally appointed. This information aims to provide an indicator of the degree of federal influence over the entity where control cannot be expressed in terms of share ownership. The government's response to the 14th Report of the Standing Committee on Public Accounts stated that federal appointees do not represent the department or the government and, like other board directors, they have a fiduciary responsibility to act in the best interests of the foundations.

4.68 Treasury Board Secretariat and Privy Council Office officials also informed us that guidance to federal appointees on their responsibilities as board directors should come from the foundations themselves. In our view, the government's position does not deal clearly with the manner in which government officials, appointed to the foundation boards, are expected to exercise federal influence.

Evaluation concerns remain

4.69 The Budget Plan commitments did not address our recommendation for a government-wide evaluation of the use of new governance arrangements, including foundations, and for the results of this evaluation to be tabled in Parliament. Reliable information from a government-wide evaluation would allow Parliament to assess whether foundations have proved to be an effective policy instrument.

Accountability framework

4.70 In our 2002 audit, we suggested a framework for new governance arrangements, including foundations. In this follow-up audit, we assessed the elements of this framework that are essential to accountability to Parliament (Appendix C). We found that these elements are still relevant and added the following as a result of our audit:

- the government's commitment to situate foundations' significant expected results within sponsoring departments' reports on plans and priorities and significant results achieved within departmental performance reports; and
- that evaluations commissioned by foundations apply recognized evaluation standards.

Conclusion

4.71 We found a number of improvements in the accountability of foundations to Parliament. However, the government's overall progress is unsatisfactory because important gaps remain in the areas of the external audit regime and ministerial oversight:

- The government has no commitment to provide for performance audits reported to Parliament. Thus, Parliament does not have adequate information and assurance on the use of more than $9 billion in public funds already transferred to foundations.
- Inadequate provision has been made for the government to adjust foundations' mandates or policy directions where circumstances have changed considerably.

4.72 We also found that

- the independence of foundations raises questions about the government's ability to ensure adequate accountability to Parliament, in particular through reporting by sponsoring departments and by foundations;
- with a few exceptions, commitments to report on results are not being met; and
- departments need leadership from the Treasury Board Secretariat—in particular, clarification of the policy framework for sponsoring departments.

4.73 The government has made commitments to improve a number of elements of the accountability framework, particularly reporting. To meet these commitments, the sponsoring departments have introduced provisions in funding agreements and have implemented a number of them.

4.74 We assessed our accountability framework for foundations and concluded that it is still relevant, with the addition of the federal government's commitments on reporting and our new element on the need for evaluation standards.

Government's overall response. The government is pleased that the Auditor General has recognized that progress has been made in improving the accountability framework relating to foundations. However, it does not share her conclusion that overall progress is unsatisfactory.

In order to evaluate the progress made, it will be important to consider the principles, as outlined in Budget Plan 2003, which the government applies when using a foundation to deliver public policy:

- Foundations should focus on a specific area of opportunity, in which policy direction is provided generally through legislation and/or a funding agreement.
- Foundations should harness the insight and decision-making ability of independent boards of directors with direct experience in and knowledge about the issues at stake.
- Decisions by foundations should be made using expert peer review.
- Foundations should be provided with guaranteed funding that goes beyond the annual parliamentary appropriations to give the foundations the financial stability needed for the comprehensive medium- and long-term planning that is essential in their specific area of opportunity.
- Foundations should have the opportunity and hence the ability to lever additional funds from other levels of government and the private sector.

In direct response to previous recommendations by both the Auditor General and the Standing Committee on Public Accounts, the government undertook in Budget Plan 2003 to strengthen the accountability regime relating to transfer payments to foundations.

Funding agreements were renegotiated and in some cases legislation was amended, to put in place measures that strengthened accountability while at the same time respecting the independence of these not-for-profit organizations.

To improve transparency and accountability, reporting to ministers, Parliament, and the public was strengthened. Ministers table in Parliament the annual reports containing audited financial statements of foundations, representing 80 percent of the transfers noted by the Auditor General.

Foundations regularly report their plans and results to departments who are required to incorporate significant items in their reports on plans and priorities and departmental performance reports to Parliament. Some of the

measures introduced, such as the requirement to situate the plans and results of foundations within those of departments, actually exceed the expectations of the Auditor General.

Regarding the audit and evaluation regime, a number of steps were taken to supplement the previous requirement for independent professionally accredited external auditors and periodic evaluations. New requirements include compliance audits to ensure adherence to the terms and conditions of the funding agreements and departmental evaluations to permit horizontal assessments of different programs. As noted in Budget Plan 2003, the Auditor General can undertake the compliance audits at the discretion of ministers. The foundations' external auditors are required under professional auditing standards of the Canadian Institute of Chartered Accountants to assess the adequacy of internal controls. Foundations are also required to report on their performance in their annual reports, which is subject to review by their external auditors, who could also conduct performance audits.

With respect to ministerial oversight, changes have been made that strengthen the default provisions of the funding agreements to enable corrective action if things go wrong. In addition, funding provisions and legislative changes have been made to permit the recovery of unspent funds in the event a foundation is wound down. It has been possible to effect other adjustments through the renegotiation of funding agreements and changes to legislation. These adjustments respect the independence of these organizations and do not involve the unilateral redirection of funds by the government. As with all transfer payments to other governments and not-for-profit organizations, funds are transferred based on agreements between arm's length organizations. It would not be appropriate for the federal government to unilaterally redirect these funds or the assets purchased with them. The government believes that the level of parliamentary and ministerial oversight is appropriate given the independence of these organizations.

Finally, with respect to the accounting for transfers to foundations, the government continues to hold the view that its accounting treatment respects the objective accounting standards of the Canadian Institute of Chartered Accountants. These are accounted for in a manner consistent with the treatment of other transfers such as those to provinces, which the Auditor General has accepted. Such transfers provide long-term stable funding that is needed to attract financial resources and expertise into areas of strategic importance. Decisions relating to such transfers take place once the government has the financial flexibility to fund these priorities. Such decisions and announcements have been made throughout the year and not only at year-end.

In conclusion, the government has taken a number of steps to strengthen overall accountability and transparency relating to transfer payments to foundations. It is willing to explore with the Auditor General those recommendations that will further improve this framework, while at the same time respecting the independence of these organizations and legitimate policy objectives sought.

About the Follow-Up

Objectives

Our audit objectives focussed on developments and potential changes to the governing framework for new governance arrangements as it applies to sponsoring departments and foundations. Specifically, we sought

- to assess the extent to which the government, central agencies, and sponsoring departments have acted to improve the accountability of government-sponsored foundations to Parliament; and
- to reassess, in light of the findings of this audit, the elements of the governing framework presented in our 2002 audit that we considered essential for effective accountability to Parliament.

Scope and approach

This follow-up audit looked at developments in accountability since January 2002 by examining three highly interrelated areas—that is, the elements of the governing framework identified in our 2002 chapter that we considered essential for accountability to Parliament:

- **Reporting to Parliament and the public**. This includes reporting by sponsoring departments as part of the Estimates process and reporting by foundations in corporate plans, annual reports (with evaluation results), and audited financial statements.
- **Ministerial oversight**. This includes strategic monitoring mechanisms (for example, compliance audit of funding agreements by sponsoring departments) and procedures to allow the government to make adjustments and deal with mandate and performance issues.
- **External audit and evaluation.** This includes broad-scope audit and a combination of credible and independent audits and evaluations.

Sample. In addition to some of the sponsoring departments and foundations we examined in 2002, we included the Aboriginal Healing Foundation as an early example of a foundation; the Pierre Elliott Trudeau Foundation to which the government first applied many of its accountability improvements; and, for comparative purposes, the Canadian Institute for Advanced Research, which has received ongoing funding as well as up-front funding. Indian Residential Schools Resolution Canada is the sponsoring department for the first foundation and Industry Canada for the other two.

Criteria

We expected that

- sponsoring departments have taken action to ensure that adequate provision for reporting of foundations' financial and non-financial performance and results to Parliament and the public is included in the enabling legislation, funding agreements, ministerial direction or other mechanisms, and that such reporting is taking place, or planned;
- sponsoring departments have taken action to ensure that adequate provision for external audit, program evaluation, and review in foundations is included in the enabling legislation, funding agreements, ministerial direction, or other mechanisms, and that such audit, evaluation, and review is taking place, or planned;
- sponsoring departments have taken action to ensure that adequate provision for ministerial oversight of foundations is included in the enabling legislation, funding agreements, ministerial direction, or other mechanisms, so that adjustments can be made in foundations' delivery of public policies, or that such a mechanism is planned; and
- the Privy Council Office, Finance Canada, and the Treasury Board Secretariat have taken a leadership role in providing guidance and developing best practices for use by sponsoring departments, and that sponsoring departments are following Treasury Board policies in setting up and monitoring foundations, and in ensuring accountability to the government and Parliament.

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Appendix A Budget Plan 2003—Commitments on the accountability of foundations

In 1997 the Government introduced a new approach to meeting the needs of Canadians—foundations. Foundations use up-front endowment funding and independent arm's-length boards of directors made up of experienced and knowledgeable individuals. Their arm's-length nature, financial stability and focused expertise allow them to address specific challenges in a highly effective, non-partisan manner. As a result, foundations have become important tools for implementing policy, in particular in areas such as research and development and education, where expert knowledge, third-party partnerships and stable long-term funding are especially important.

To clarify the circumstances under which foundations are used by the Government, this budget sets out principles which the Government would consider in using a foundation to deliver public policy:

- Foundations should focus on a specific area of opportunity, in which policy direction is provided generally through legislation and/or a funding agreement.
- Foundations should harness the insight and decision-making ability of independent boards of directors with direct experience in and knowledge about the issues at stake.
- Decisions by foundations should be made using expert peer review.
- Foundations should be provided with guaranteed funding that goes beyond the annual parliamentary appropriations to give the foundations the financial stability needed for the comprehensive medium- and long-term planning that is essential in their specific area of opportunity.
- Foundations should have the opportunity and hence the ability to lever additional funds from other levels of government and the private sector.

These policy principles are consistent with the Treasury Board's new Policy on Alternative Service Delivery, which came into effect on April 1, 2002.

A key ingredient of the success of foundations is their independence. However, this has led to some concern as to their transparency and accountability. Current funding agreements with foundations specify their mandates and the conditions under which they operate. Further, directors are fully responsible for the actions of foundations, and all foundations are subject to annual independent audits of their financial statements.

As part of its ongoing effort to improve transparency and accountability, the Government will make a number of changes to improve the accountability of foundations to Canadians and parliamentarians.

Parliamentary Approval: The Government is taking steps to ensure that the establishment and funding of foundations is adequately reviewed by Parliament.

- The Government is committed to parliamentary approval of purpose and funding through direct legislation for those foundations that are significant either from a policy or financial perspective. In all cases Parliament will need to approve funding for foundations. As noted above, the Government's use of foundations will respect the requirements of the Treasury Board's Policy on Alternative Service Delivery.

Public Reporting: To improve the transparency and therefore the accountability of foundations to the public, the Government will take the following steps:

- Foundations will be required to provide corporate plans annually to the Minister responsible for administering the funding agreement over the duration of the agreement. Such corporate plans will include planned expenditures, objectives and performance expectations relating to the federal funding. Summaries of these plans will be made public by the responsible Minister and provided to Parliament.
- In addition, the departmental Reports on Plans and Priorities, which are tabled in Parliament, will incorporate the significant expected results to be achieved by the relevant foundations and situate these within the Department's overall plans and priorities. As well, the Department responsible for administering the funding agreement will report on the significant results achieved by the foundation(s) in its Departmental Performance Report for the duration of the funding agreement and situate these within the Department's overall results achieved.

- The Annual Report for each foundation, including relevant performance reporting, audited financial statements and evaluation results, will be presented to the Minister responsible for the funding agreement and made public. The Annual Reports of foundations created explicitly through legislation will be tabled in Parliament by the responsible Minister.
- All foundations' Annual Reports will contain performance information as well as audited financial statements prepared in accordance with Generally Accepted Accounting Principles. As foundations are independent, not-for-profit organizations that have their own governance structures and members, it is the members, as "shareholders" of the foundation, who appoint their external auditor and to whom the external auditor reports.

Compliance With Funding Agreements: The accountability of foundations will be further enhanced through the following measures:

- Foundations will be required to conduct independent evaluations, present these to the Minister responsible and make them public. Departments will incorporate any significant findings in their annual Departmental Performance Reports, which are tabled annually in Parliament.
- Funding agreements reached with foundations arising from the 2001 budget contain provisions for independent audits of compliance with funding agreements and for program evaluations. There will also be provisions for intervention in the event the responsible Minister feels there have been significant deviations from the terms of the funding agreement. The provisions will provide for dispute resolution mechanisms.
- Further, in all new funding agreements provisions will be put in place so that the responsible Minister may, at his/her discretion, recover unspent funds in the event of winding up.

The above is on a going-forward basis. The Government will also consult with existing foundations to explore making changes to their agreements with the Government to incorporate these new requirements.

The adoption of these requirements addresses many of the issues about accountability of foundations that were raised in the April 2002 Report of the Auditor General of Canada.

Appendix B Description of foundations in the audit

Foundations and sponsoring departments	Description
Eight foundations followed up from the April 2002 audit	
Canada Foundation for Innovation Established in 1997 Industry Canada	An independent, non-profit corporation created under the *Budget Implementation Act,* 1997 for the purpose of making grants to universities, colleges, hospitals, and other not-for-profit institutions to increase the capability of carrying out high-quality research in Canada.
Canada Health Infoway Inc. Established in 2001 Health Canada	A non-profit corporation whose purpose, through collaboration with the public and private sector, is to accelerate the development and adoption of modern systems of information and communication technology in the health sector while ensuring common standards and interoperability.
Canadian Health Services Research Foundation Established in 1997 Health Canada	The foundation's mission is to support evidence-based decision making in the organization, management, and delivery of health services through funding research, building capacity and transferring knowledge.
Canada Millennium Scholarship Foundation Established in 1998 Human Resources and Skills Development Canada	An independent body created through the *Budget Implementation Act,* 1998 to manage a $2.5 billion federal endowment for 10 years starting in 2000. It grants scholarships to students.
Genome Canada Established in 2000 Industry Canada	Genome Canada invests and manages large-scale projects in key selected areas such as agriculture, environment, fisheries, forestry, health, and new technology development. Genome Canada also supports research projects aimed at studying and analyzing the ethical, environmental, economic, legal, and social issues related to genomics research.
The Green Municipal Enabling Fund (GMEF) and Green Municipal Investment Fund (GMIF) Established in 2000 Natural Resources Canada and Environment Canada	The Federation of Canadian Municipalities administers these funds. The GMEF provides cost-shared grants for feasibility studies on projects designed to improve air, water, and soil quality. The GMIF provides interest-bearing loans, loan guarantees, and grants that enable recipients to carry out energy and environmental projects in municipal operations.
Sustainable Development Technology Canada Established in 2001 as the Foundation for Sustainable Development Technology in Canada Natural Resources Canada and Environment Canada	An arm's-length foundation, established by federal legislation to provide funding to consortia from the private sector, universities, research organizations, and not-for-profit corporations for technology development and demonstration, namely for climate change and air quality solutions. The foundation will complement sustainable development activities of other government departments.

Foundations and sponsoring departments	Description
Three additional foundations referred to in this audit	
Aboriginal Healing Foundation Established in 1998 Indian and Northern Affairs Canada*	The foundation is funded by the Government of Canada to support the projects and programs that address the healing needs of Aboriginal people affected by the legacy of abuse in residential schools.
Canadian Institute for Advanced Research Established in 1982 Industry Canada	A corporation that provides researchers with the means to meet, interact, and collaborate with peers from across Canada and around the world to respond to the scientific and social challenges of tomorrow.
The Pierre Elliott Trudeau Foundation Established in 2001 Industry Canada	Created as a not-for-profit corporation, the foundation seeks to commemorate the late Prime Minister Pierre Elliott Trudeau by funding advanced study and research in Canada in the humanities and human sciences. The foundation also grants fellowships to mid-career researchers and mentorships to seasoned professionals who work in the field of public policy.

* The sponsoring department is now Indian Residential Schools Resolution Canada

Appendix C Our accountability framework for foundations

Changes to the governing framework since our April 2002 Report are in italics.

Element	Description
To ensure accountability to Parliament	
Reporting to Parliament and the public	
Corporate plans	Plans including objectives, strategies to be pursued, and expected accomplishments should be made public and tabled in Parliament. Provision for an initial corporate plan and an update at least every three years would be reasonable. *The significant results expected from the relevant foundation should be situated within the department's overall plans and priorities in its Report on Plans and Priorities.*
Annual performance reporting, including audited financial statements	Timely, appropriate, and credible information on the extent to which the *foundation* has accomplished its federal policy objectives, and at what cost, should be reported to the ministers responsible, Parliament, and the public in an annual report or a departmental performance report, as appropriate. *The significant results achieved by the foundation should be situated within the department's overall results, reported in its Departmental Performance Report.*
Evaluation results	The findings from independent evaluations should be tabled in Parliament.
External audit *and evaluation* regime	
Performance audit reported to Parliament	In *foundations*, the external auditor should carry out attest, compliance, and *performance* audits. In all cases, audits would be reported to the board of directors, the sponsoring minister, and Parliament.
Evaluation standards	*Sponsoring departments should ensure that evaluations commissioned by foundations pursuant to legislation or funding agreements apply recognized evaluation standards.*
Ministerial oversight	
Strategic monitoring mechanisms, including compliance audit	Strategic monitoring by the sponsoring department should be in place to ensure that timely information is available on stewardship, the results achieved, and overall compliance with terms and conditions.
Procedures to deal with non-performance	Reasonable provisions should be in place to deal with non-performance of the *foundation*, and termination, if needed. In *foundations*, the government should be able to intervene in the exceptional case where the public purpose of the arrangement is clearly not being met or circumstances have changed considerably since the creation of the arrangement. In the event of termination, or windup for any reason, the federal government should be able to recover any remaining federal moneys.

Appendix D Progress on recommendations

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.37 If the federal government decides to create delegated arrangements that involve significant changes in policy or significant commitment of public funds or assets, it should do so through direct legislation. The Privy Council Office should ensure that this legislation meets the essential requirements for good governance and accountability to Parliament.		Accepted regarding direct legislation No clear response from the Privy Council Office	○
1.49 To ensure adequate reporting to Parliament on delegated arrangements, sponsoring ministers should table the following in a timely manner: • multi-year plans [now called corporate plans]; • the findings of evaluations; and • annual reports on what has been accomplished that include audited financial statements. These documents should be referenced in the sponsoring departments' Estimates documents.	That the government seek every opportunity to persuade existing foundations to incorporate amendments to their accountability and reporting framework that will strengthen the reporting to Parliament and to the public, including the reporting of performance expectations, performance results achieved, and disclosure of audited financial statements and evaluation reports.	Accepted	●
	That the government seek amendments to the funding agreements of existing foundations, either created through legislation, or receiving significant funding (at least $500 million) from the federal government, that would require them to table in Parliament separate annual reports, reports on plans and priorities, and departmental performance reports.	Rejected	

● Satisfactory ○ Unsatisfactory

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.54 The federal government should ensure that adequate mechanisms are in place for broad-scope audit of all delegated arrangements. The Auditor General should be appointed as the external auditor of foundations, with a few exceptions.	That for those foundations either created through legislation, or receiving significant federal funding (at least $500 million), the federal government seek amendments to the funding agreements that provide for periodic program evaluation, value-for-money audits, and independent assessment of the fairness and reliability of the performance information, the results of which are to be reported through ministers to Parliament. That for those foundations either created through legislation, or receiving significant federal funding (at least $500 million), the federal government appoint the Auditor General of Canada as external auditor of these foundations.	Rejected	
1.62 The federal government should ensure that an adjustment mechanism is in place that allows sponsoring ministers to intervene in a delegated arrangement in the exceptional case where the arrangement is clearly not meeting its public purpose or where circumstances have changed considerably since its creation.	That the government seek every opportunity to persuade all existing foundations to incorporate into their existing accountability and governance framework, new provisions that will strengthen the ministerial oversight function, including strategic monitoring, redress procedures in case of non-performance, clearly defined provisions enabling departmental audit and evaluation of foundation activities, and mechanisms to recover unspent federal funds in case of the winding up or termination of the foundations.	Accepted in part for extreme situations	○
1.63 The federal government should ensure that provision is made to allow sponsoring departments to undertake compliance audits of delegated arrangements.		Accepted	●
1.64 In the event of the winding up or termination of any delegated arrangement, the federal government should recover unspent federal funds.		Accepted	●
1.69 The Privy Council Office should ensure that departments fully define the roles and responsibilities of federal appointees to boards of delegated arrangements. The federal government should resolve the issue of the potential conflict of duties.		Rejected	

● Satisfactory ○ Unsatisfactory

Recommendations of our April 2002 Report, Chapter 1	Recommendations of the 14th Report of the Standing Committee on Public Accounts	Recommendation accepted or rejected by the government	Progress made by the government
1.115 The Treasury Board Secretariat should ensure that its database on alternative service delivery collects and makes available adequate information on the types and number of new governance arrangements created by federal departments. The database should also provide government managers with information on lessons learned and good practices by arrangements.		Accepted	●
1.116 The Treasury Board Secretariat should review exemptions to the Treasury Board policy against making payments in advance of need. The findings of this review should be reported to Parliament.		Rejected	
1.117 The Treasury Board Secretariat should develop an evaluation framework and undertake, after a suitable interval, a government-wide evaluation of the use of new governance arrangements as instruments of public policy. The results of this evaluation should be reported to Parliament.		Rejected	

● Satisfactory ○ Unsatisfactory

Chapter

5

Canadian International Development Agency

Financial Compliance Audits and Managing Contracts and Contributions

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canadian International Development Agency

Financial Compliance Audits and Managing Contracts and Contributions

Main Points

5.1 Overall, CIDA has made satisfactory progress on our recommendations made in 1999 and 2000. Progress has been made in the key areas of competition of agreements, deposits to counterpart funds, the monitoring of project risks and sustainability of benefits, and the documentation of decisions related to its audits of contribution agreements.

5.2 We noted improvement in CIDA's use of non-competitive contributions. In the files we examined, the use of unjustified sole-sourcing of contributions had decreased significantly. In addition, the total value of sole-source contracts awarded had decreased significantly since our previous audit. For the counterpart funds we audited, we found only minor cases of non-compliance with CIDA policy.

5.3 In 1999 we observed that CIDA rarely documented the rationale for its decisions not to recover amounts found to be in error by its financial compliance audits of contribution and contract agreements. CIDA has improved its documentation of this type of decision, but in the files we examined, half of such decisions had still not been justified or were not properly documented.

5.4 During the course of our follow-up, we became aware of weaknesses in three additional but related areas: in-kind contributions, authorities for releasing amounts due from executing agents, and the management of grants. We found that CIDA officers rarely analyze the value of in-kind contributions that recipients of its funding claim they will make or verify that there is no provision for profit by the recipient—as is required by CIDA policy. In many cases, CIDA officers decided to release the Canadian executing agencies from the obligation to repay money received for expenditures that were not covered under the terms of their agreements. Since our 2000 audit, CIDA has sharply increased the use of grants rather than contributions to fund aid projects. We are concerned that, without having assessed the probable impact on expected development results, by using grants CIDA may be sacrificing a degree of control and oversight over how recipients spend CIDA funding. CIDA also disbursed grant funds in advance of need without a proper explanation on file.

Background and other observations

5.5 The primary objective of this follow-up was to assess what CIDA had done to address the issues and recommendations that were raised in two of our previous reports, the November 1999 Report, Chapter 28, Canadian

International Development Agency—Financial Controls over Projects; and the October 2000 Report, Canadian International Development Agency—Managing Contracts and Contribution Agreements. The follow-up focussed on four main areas: the process for awarding contracts and contribution agreements related to aid projects, how CIDA has responded to the results of financial compliance audits concerning non-compliance with agreement terms, controls over payments into counterpart funds, and project implementation processes for managing project risks and outcomes. We did not follow up on several other issues raised in those chapters including: general financial controls, project design, or Partnership Branch agreements. We also audited three additional issues related to the previous observations: in-kind contributions by recipients, the use of grant agreements, and the authorities related to non-collection of amounts identified for recovery by financial compliance audits.

5.6 CIDA is responsible for managing about $2.6 billion of Canada's international assistance. The Agency's program expenditures consist of transfer payments made to its executing agents and partners under the terms of the formal funding agreements. These include contracts, contribution agreements, and grant agreements. Government Contracts Regulations and the Treasury Board contracting policy govern the awarding of aid contracts. CIDA's contributions and grants are governed by the Treasury Board approved Terms and Conditions for International Development Assistance and the associated framework policy.

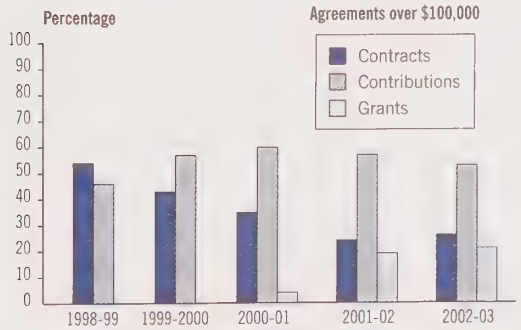
The Canadian International Development Agency has responded. CIDA has indicated the actions it intends to take to address the recommendations. Its detailed response follows each recommendation throughout the chapter.

Introduction

5.7 This audit is a follow-up of key issues raised in two previous audits that our Office carried out. In November 1999, we reviewed the financial controls that CIDA had put in place for managing its development projects. In October 2000 we examined how CIDA managed its contracts, contribution agreements, and other types of agreements for goods and services, including the selection of Canadian executing agencies to deliver projects. The Public Accounts Committee held one hearing on the 2000 Chapter and issued a report that supported our observations and recommendations.

5.8 The Canadian International Development Agency is responsible for managing about $2.6 billion of Canada's international development assistance. CIDA's program expenditures consist of contracts, contributions, grants, and other transfer payments. CIDA makes these payments to institutions in Canada and developing countries, provincial governments and their organizations and agencies, and to Canadian private-sector firms. Payments relate to funding specific development projects, programs, and activities. CIDA's relationship with its partners is governed by the formal agreements they sign with these organizations. Exhibit 5.1 shows the distribution of contracts, contributions, and grant agreements over $100,000 by dollar value in the Geographic Branches, excluding food aid. The Geographic Branches carry out geographic programs, also referred to as bilateral or country-to-country programs; they also manage contracting and other types of agreements for goods and services, including the selection of Canadian executing agencies to deliver projects.

Exhibit 5.1 Distribution of contract, contribution, and grant agreements over $100,000 in CIDA's Geographic Branches



Source: CIDA (unaudited)

5.9 CIDA is accountable for selecting its partners and for developing and managing its agreements with them. The awarding of contracts for both aid and corporate services is subject to Government Contracts Regulations and Treasury Board contracting policy. CIDA's grant and contribution agreements are not subject to the Government Contracts Regulations and are governed

by the Terms and Conditions for International Development Assistance approved by Treasury Board effective 22 March 2001 and the associated Framework Policy for International Development Assistance.

Focus of the follow-up

5.10 The primary objective of this follow-up was to assess what CIDA had done to address the issues and recommendations that were raised in our two previous reports:

- We examined the contractor-selection process for contracts, contribution agreements, and grants to ensure that they respected Treasury Board directives, the Terms and Conditions for International Development Assistance, and CIDA's internal policies. Our focus was on ensuring that, when required, CIDA carried out a proper competitive-selection process.
- We assessed how CIDA had dealt with the results of financial compliance audits of contracts and contributions.
- We reviewed a set of issues around controls for payments to counterpart funds that we raised in 2000 (and previously in 1998).
- We reviewed the progress that CIDA has made regarding various project implementation issues.

5.11 Further details about the follow-up can be found in **About the Follow-Up** at the end of the chapter.

Observations and Recommendations

Contractor selection

Competitive and non-competitive contribution agreements

5.12 An open, competitive bidding process provides the best guarantee that qualified vendors will have a fair chance to do business with the government and that the government will receive good value for its contracting dollars. The Government Contracts Regulations affirm that competition is the norm, and that departments are to solicit bids before entering into a contract. It is also standard government practice to award contributions without competition to support non-governmental organization projects or activities.

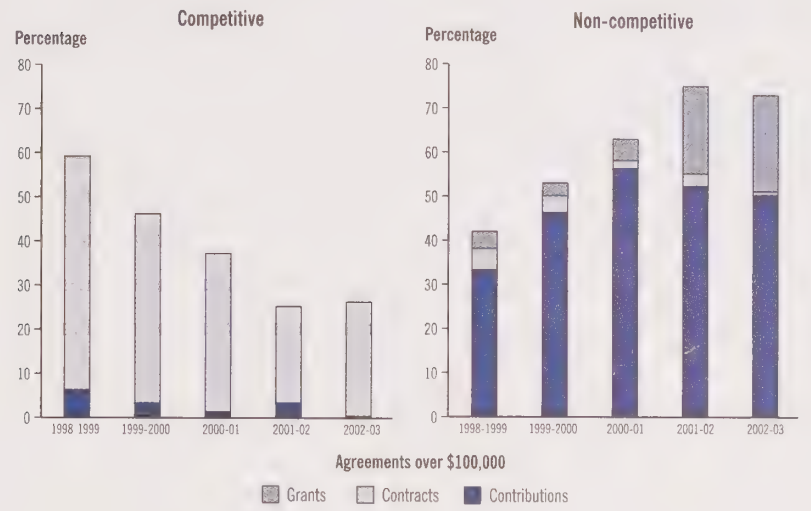
Contributions—Conditional transfers in which specific terms and conditions must be met or carried out by the recipients before costs are reimbursed.

Grants—Unconditional transfer payments, where eligibility criteria and applications received in advance of payment is sufficient assurance that the payment objectives will be met.

5.13 Exhibit 5.2 shows the distribution of competitive and non-competitive agreements over $100,000 signed in the Geographic Branches from 1998–99 to 2002–03. These include goods and services contracts, contributions, and grants. CIDA's Manager's Guide to Contribution Agreements explains the main features of both contracts and contribution agreements in CIDA (see Exhibit 5.3); it does not cover grants.

5.14 In our 2000 audit, we said that over the years CIDA had subscribed to the principles of competition for contracts, but not for contribution agreements. We noted that CIDA's terms and conditions for contribution agreements that Treasury Board had approved in 1996 were very general. The terms and conditions did not provide any direction on the use of either

Exhibit 5.2 Competitive and non-competitive agreements over $100,000 in CIDA's Geographic Branches



Source: CIDA (unaudited)

the competitive or non-competitive approaches to entering into contribution agreements. We found that the lack of clear direction had resulted in instances in which CIDA staff used a non-competitive process for contributions relating to solicited proposals when, according to the then-current policy, they should have followed a competitive process.

5.15 In June 2000, Treasury Board issued a new policy on transfer payments (grants and contributions). The objective of the policy is "to ensure sound management of, control over and accountability for transfer payments." The policy calls for departments and agencies to submit for approval new terms and conditions for their transfer payment programs before April 2005.

5.16 In our 2000 audit, we recommended that CIDA should include a framework that clarifies how and when it will use contribution agreements when submitting its next set of terms and conditions to the Treasury Board for approval in 2001. In response, CIDA said that it would introduce a more structured framework to provide better guidance to CIDA staff on using contribution agreements, especially for solicited proposals.

CIDA updated its policies on contribution agreements, but gaps exist

5.17 CIDA received Treasury Board approval for its renewed Terms and Conditions for International Development Assistance in March 2001. They included a Framework Policy for International Development Assistance. However, these documents did not include a clearer framework for using contribution agreements. Unlike the framework that governs contracts, CIDA's Terms and Conditions and the Framework Policy for International Development Assistance still do not clarify the circumstances under which a competitive or a non-competitive process can be used for contribution agreements involving non-responsive/solicited proposals.

Exhibit 5.3 Main features of contract and contribution agreements in CIDA

	Contract	Contribution
Purpose	To engage the services of a supplier, purchase goods, and/or lease real property	To provide funding to an independent party's development project
Legal status	Legally binding	Legally binding
Subject to	• Trade agreements • Government Contracts Regulations • Contracting authorities delegated by Treasury Board • CIDA contracting policies	• Treasury Board Policy on Transfer Payments • CIDA's Terms and Conditions for International Development Assistance (approved by Treasury Board) • CIDA's Framework Policy for International Development Assistance Note: While contribution agreements are not subject to the Government Contracts Regulations and Treasury Board contracting policy, CIDA project managers are expected to reflect the spirit of the Government Contracts Regulations when using contribution agreements.
Profit	Profit is allowed for the proponent and subcontractors	No profit is allowed for the proponent
Cost-sharing	Not applicable	Taken into account when assessing proposals
Agreement mechanism	**Must be open to competition**, with four types of exceptions allowed for sole-sourcing under the Government Contracts Regulations. The exceptions, when used inappropriately, are the focus of our audit observations.	**Responsive** (idea proposed to CIDA): No competition is required. **Non-responsive/solicited** (idea originates in CIDA): CIDA requires competition as the norm, with undefined exceptions allowed. These exceptions are the focus of our audit observations, in cases where they would not meet the four exceptions under the Government Contracts Regulations if they were contracts.

Source: Adapted from CIDA's Manager's Guide to Contribution Agreements

5.18 The Government Contracts Regulations and the Treasury Board contracting policy do not apply to contributions. However, CIDA's Manager's Guide to Contribution Agreements indicates that "project managers are expected to reflect the spirit of the Government Contracts Regulations when using contribution agreements."

5.19 CIDA's Contracting Guide for Managers, which was issued in 2000, included a chapter on using contributions. CIDA's Manager's Guide to Contribution Agreements, which was published in 2002, helps staff to better understand how they can use contribution agreements to advance the Agency's programming priorities. Both the Manager's Guide to Contribution Agreements and the Contracting Guide for Managers try to clarify the circumstances under which the process for awarding contributions should be competitive or non-competitive. Both guides indicate that for responsive/

unsolicited proposals (that is, when an outside agency has developed the idea for a project), non-competitive contribution agreements may be used. For non-responsive/solicited proposals (those for which CIDA has originated the idea for a project), competitive contributions are appropriate. Both documents allow for exceptions.

5.20 For example, CIDA's Contracting Guide for Managers says that, "whenever practical," competition is the rule for solicited proposals for contributions. However, neither the Contracting Guide for Managers nor the Manager's Guide to Contribution Agreements clearly defines the circumstances under which exceptions are allowed. As a result, there is uncertainty about when a non-competitive contribution can be used in a situation where CIDA solicited the proposal. Although our sample showed much less use of sole-sourcing than in the sample in our 2000 audit, we still found instances where CIDA awarded contributions without competition for solicited proposals. This continuing uncertainty has led us to conclude that the problems we observed in our 2000 audit with the use of contribution agreements have not been conclusively resolved by CIDA policies.

5.21 We audited 19 contribution agreements out of a total of about 1,400 agreements that were over $100,000 in value, and that were awarded between January 2001 and August 2003. Nine files were coded as "responsive contribution agreements" (that is, arising from unsolicited proposals), and these contributions were awarded without competition, which was according to CIDA policy. Another ten files were coded as "traditional contribution agreements" (that is, those that were not open for competition). In our opinion, two of those agreements should have been open to competition because CIDA solicited them, and the files showed that there may have been other potentially qualified suppliers. Those two did not follow CIDA policy. Overall, these results were a considerable improvement over our findings in 2000 where 6 of 11 contributions we audited had not followed CIDA policy.

5.22 In 2000, we recommended that a separate group within CIDA should review all proposed non-competitive contracts and contribution agreements over $100,000 for compliance with authorities and CIDA policy. CIDA agreed to act on this recommendation. In our follow-up, we found that CIDA had decided that each branch would carry out its own reviews but did not make them mandatory. For the non-competitive contracts and contribution agreements that we audited, we saw no evidence on file of any such review.

CIDA managers do not consistently verify recipients' share of contributions

5.23 In contribution agreements, the recipient often provides its own contribution toward the project, which may be "in-kind" such as volunteer time or donated equipment. The nature and extent of the recipient's own contribution is an important element in CIDA's decision to award a contribution. CIDA's Manager's Guide to Contribution Agreements states that contribution agreements should clearly indicate the nature, dollar value, and terms and conditions attached to in-kind contributions. We expected that CIDA would have verified the nature of the in-kind contributions, and

that they had, indeed, occurred. However, this was not the case. The Contribution Guide does not give guidance on how to verify the existence or value of in-kind contributions. We found that managers had usually noted the recipient's intention to provide in-kind contributions in the contribution agreements. However, these agreements had not always clearly indicated what the in-kind contributions were to be. Of the 19 files that we reviewed, 12 had in-kind contributions. For 11 of those, we found no indication on file that CIDA had analyzed the in-kind contributions that were to be part of the contribution agreement, to determine their true value.

5.24 The Contribution Guide also states that no profit may be associated with a contribution agreement. Only 3 of the 19 contribution agreements that we audited showed evidence that CIDA had considered the elements of the project costs to ensure that no profit factor had been included.

5.25 **Recommendation.** CIDA should clarify the specific circumstances under which it considers awarding an agreement on a sole-source basis for solicited contributions acceptable.

CIDA's response. CIDA agrees with this recommendation and will develop a clear definition and clarify the context for the use of solicited contributions. By 1 February 2005, the necessary changes will be incorporated into CIDA's Manager's Guide to Contribution Agreements and into the Agency's training courses on the management of contributions.

5.26 **Recommendation.** CIDA's Manager's Guide to Contribution Agreements should make clear the steps required to analyze the value of proposed in-kind recipient contributions and that there is no provision for profit. Guidance should also be provided on how to verify that the recipient has made its contribution as agreed.

CIDA's response. CIDA agrees with this recommendation. Accordingly, by 1 February 2005, the Agency will define acceptable in-kind contributions from its development partners, develop criteria for assessing their value, and formulate guidelines for verifying that development partners have made in-kind contributions identified in contribution agreements. The Agency will also develop measures to ensure that there is no provision for profit in its contribution agreements. These will be incorporated into the Agency's Manager's Guide to Contribution Agreements as well as into training courses on the management of contributions.

Contract agreements

Sole-sourcing and contract splitting

5.27 In our 2000 audit, we observed instances in which contracts did not comply with either the Treasury Board contracting policy or the Government Contracts Regulations. In 2002, CIDA's internal audit unit published a report on the use of contracts awarded on a sole-source basis. The report highlighted several problems with the manner in which CIDA had applied Treasury Board policy, and included a number of recommendations for improvement. A follow-up audit was carried out in the fall of 2003 to assess the progress that CIDA managers had made toward respecting the policy. That audit had not yet been completed at the time our field work ended.

5.28 In our follow-up, we found that considerable progress had been made in this area, as the dollar value of sole-source contracts awarded in CIDA has decreased significantly since our 2000 audit. We selected five, large, sole-source contracts awarded after 2000 to determine whether CIDA had followed Government Contracts Regulations and Treasury Board policy in awarding these contracts. We again found cases where the Agency had not complied with government policy in this area. In our view, three of the five contracts we examined should have been open to competition.

5.29 One contract showed evidence of contract splitting, although both the Treasury Board policy and Public Works and Government Services Canada guidelines forbid this practice. It was one of two similar contracts to Hydro Quebec International for $95,000 and $98,000 that were let sequentially and fell just under the approved dollar threshold of $100,000 for sole-source contracts. Another contract of $62,000 for government-on-line development had been let as an aid contract instead of an administrative contract. The permitted dollar-threshold for sole-sourcing administrative contracts is $25,000, while the threshold for aid contracts is $100,000. Therefore, it should have been awarded on a competitive basis.

5.30 **Recommendation.** CIDA should ensure that the Government Contracts Regulations and the Treasury Board policy regarding the sole-sourcing of contracts are respected in all cases.

CIDA's response. The Agency agrees with this recommendation. CIDA will remind its contract officers of the Treasury Board's rules and guidelines associated with sole-source contracting. CIDA will implement a contracting compliance and performance monitoring function, at the outset of fiscal year 2005–06, that will include monitoring the compliance of sole-source contracts with the Treasury Board rules and government regulations and with CIDA contracting templates. The results of such monitoring will be reported to the Agency's Audit and Evaluation Committee on a regular basis.

Implementation

"Off-ramps" for larger agreements have not been implemented

5.31 In 2000, we noted that to have a large project planned and approved, tendered, contracted, and operationally planned can take anywhere from one to four or five years. It involves considerable expense and effort on the part of both CIDA and the host country partner. Given this large investment in resources, it is difficult for CIDA to decide to cancel the agreement when the expected results from the project are not forthcoming. CIDA did not build into its management of project agreements any formal requirement or mechanism for "off-ramp" provisions (clauses that allow CIDA to make a decision to withdraw from a project). We recommended that CIDA build a provision for a formal review point into its larger service agreements at which time a decision could be made on whether the project should be continued, cancelled, or have the scope changed. CIDA agreed.

5.32 In this audit, we found that CIDA has not done this. In the 24 contracts and contribution agreements examined, with the exception of

one case, there were no specific off-ramp provisions included, other than the standard clauses for ending an agreement.

CIDA is doing a better job of monitoring risks and ensuring sustainability

5.33 In our 2000 audit we observed that generally CIDA and its executing agencies had been slow or unable to take responsibility to react when critical assumptions failed to materialize, and problems ensued. During our field visits as part of this follow-up, we found that for the projects we visited, CIDA and the Canadian executing agents' staff were monitoring project risks and updating critical assumptions.

5.34 A sustainable project is one whose benefits last after aid funding stops. For CIDA, sustainability is one of eight key factors that the Agency uses to measure a project's success. In our 2000 audit, we noted that CIDA should be more consistent in making sure that its agreements with Canadian executing agencies contain built-in provisions to ensure sustainability.

5.35 In this follow-up, our sample included 17 agreements where specific clauses related to sustainability would have been relevant. Fifteen of those agreements did contain clauses indicating how the Canadian executing agency would support or help ensure that the project would yield sustainable benefits. This represents a substantial improvement over what we found in our previous audit. We also found during our field visits that for the relevant cases, CIDA and Canadian executing agency staff were generally monitoring project activities designed to ensure sustainability of the project benefits.

5.36 Grants and contributions are two of CIDA's key funding mechanisms. Exhibit 5.4 highlights certain key aspects of these two funding mechanisms.

Exhibit 5.4 Important differences between grants and contributions

CIDA uses grants and contributions to transfer funds to organizations involved in aid projects. These mechanisms differ in several key respects.

Contributions differ from grants in the management requirements that general government policy imposes on departments and on the recipients. An individual or organization that meets the eligibility criteria for a grant can usually receive the payment without having to meet any further conditions. In contrast, contributions are subject to performance conditions that are specified in a contribution agreement. The recipient must show that it continues to meet the performance conditions over the life of the agreement in order to be reimbursed for specific costs. The government can audit the recipient's use of a contribution, whereas audits are not required for grants.

For contributions, interest earned on CIDA payments must be used for the purpose of the program or project; unexpended balances must be repaid; and typically, there is a 10 percent holdback provision. Grants are unconditional transfer payments, and these provisions do not apply.

Source: CIDA and our reports

CIDA has sharply increased the use of grants in the past three years

5.37 When carrying out this audit, we noted that since the 1999–2000 fiscal year, the trend toward grants has increased markedly. The sharpest increase

coincided with the new Terms and Conditions for International Development Assistance approved by the Treasury Board on 22 March 2001. This document allows CIDA to use grants according to "channels-of-delivery." This term, channel-of-delivery, refers to the type or purpose of aid, for example, bilateral aid; international humanitarian assistance; or assistance against hunger, malnutrition, and disease. The previous terms and conditions had placed restrictions on certain branches in the organization; for example, the former Bilateral Branches (now termed the Geographic Branches) had not been allowed to give grants. The new terms and conditions allow grants for the bilateral aid channel-of-delivery only on an exception basis.

5.38 The Terms and Conditions for International Development Assistance approved by the Treasury Board in 2001 delegate funding authority to CIDA. CIDA's Framework Policy for International Development Assistance is intended to further articulate a number of criteria for using grants or contributions, depending on CIDA's channels-of-delivery. The terms and conditions called for CIDA to continue publishing the specific criteria for individual channels-of-delivery in program documents. We found that since issuing the terms and conditions, CIDA has published no further specific criteria for using particular channels-of-delivery.

5.39 CIDA believes that grant support to the programs of multilateral institutions improves development results and reduces its own risks. In September 2002, CIDA issued a new policy statement on strengthening aid effectiveness, *Canada making a difference in the world.* It explains that the international community has identified principles of effective development and that there is a need to move toward more comprehensive and integrated approaches. In this context, CIDA intends to rely less on its traditional projects and more on a program approach. This involves co-ordinating with other donors and integrating its aid activities with the policies and plans of recipient governments.

5.40 Contributing to the programs of multilateral institutions provides CIDA's geographic programs with opportunities to benefit from those institutions' established delivery capacities, extensive field presence, technical expertise, and local credibility. CIDA also benefits from the due diligence efforts, technical and country expertise, and programming experiences of other donors. CIDA considers that the risk of non-performance associated with multilateral institutions is relatively low compared with traditional stand-alone projects using executing agencies working under a contract or contribution agreement.

5.41 Exhibit 5.5 shows the trend for the 1999–2000 to 2002–03 period. The use of grants by the Geographic Branches increased from approximately $6 million to $148 million, or from less than one percent to over eight percent of total Agency grants and contributions. The proportion of grants to the total amount of CIDA grants and contributions has increased from approximately 26 percent to 38 percent for the same time period.

5.42 We decided to select eight grants for more detailed audit. Our objective was to determine why CIDA was using grants as opposed to other funding

Exhibit 5.5 CIDA grants and contributions 1999–2000 to 2002–03 ($ millions)

	Grants				Contributions		Grants and contributions
	Geographic Branches (including former Bilateral Branches)		Agency total		Agency total		Agency total
Fiscal year	$	%	$	%	$	%	$
1999–2000	6.1	0.4%	374.4	25.7%	1,083.0	74.3%	1,457.4
2000–01	13.7	0.9%	498.2	31.8%	1,070.3	68.2%	1,568.5
2001–02	74.3	4.3%	625.2	36.6%	1,082.7	63.4%	1,707.9
2002–03	148.1	8.4%	660.3	37.6%	1,095.6	62.4%	1,755.9

Source: CIDA (unaudited data)

mechanisms. We also aimed to assess certain aspects of CIDA's administration of grants to the recipients.

5.43 The particular channel-of-delivery was not clearly indicated on file for five of the grants that we examined, and it was difficult for us to identify the channel based on the broad descriptions in the framework policy.

5.44 According to feedback from project officers and the descriptions of channels-of-delivery in the framework policy, three of the eight grants in our sample could belong to the bilateral-aid channel. The policy states that

> Bilateral Aid is provided through projects and programs with eligible recipients, in accordance with the objectives of the Canadian foreign policy and the Official Development Assistance program, which are within the general categories of economic and development assistance.

Program finance staff charged the grants to the multilateral-institutional-funding channel, which "promotes sustainable development and supports humanitarian assistance by providing core funding support and support to multilateral institutions and by providing funding for global programs of multilateral institutions." For example, CIDA gave a grant to the Inter-American Development Bank for the implementation of a new procurement system for the Government of Nicaragua. Although this initiative could be interpreted as belonging to the bilateral-aid channel-of-delivery, it was charged to the multilateral-institutional-funding channel by CIDA program finance staff.

5.45 The Framework Policy calls for the use of contributions when funding the bilateral-aid channel. All proposals for exceptions are to be submitted to the Vice President, Human Resources and Corporate Services, who must undertake appropriate consultations before recommending to the Executive Committee and the President that the minister approve the exception. For

the three grants that could be considered as being under the bilateral-aid channel-of-delivery, there was no indication on file that CIDA officers followed the required procedure for exceptions to the policy by obtaining proper approvals for this channel-of-delivery. The three grants were coded to another channel-of-delivery that did not require special approval.

5.46 Given the broad definitions of channels-of-delivery, we are concerned that grants may be used for bilateral aid without proper authorization because they have been improperly categorized.

5.47 **Recommendation.** CIDA should continue publishing specific criteria for individual channels-of-delivery in program documents. The channels-of-delivery should be defined more precisely and should be clearly documented in grant files. CIDA officers should obtain proper authorization for bilateral grants.

CIDA's response. CIDA agrees with this recommendation. While the Agency believes that its files almost invariably identify accurately the channel-of-delivery through which its grants are made, the Agency also acknowledges the importance of having well-defined channels-of-delivery and ensuring that the channel-of-delivery is accurately identified in project files. Accordingly, by 1 February 2005, the Agency will review the current definitions and incorporate any changes in definition into documents such as the Manager's Guide to Contribution Agreements and the Explanatory Notes for the Delegation of Selection Authorities and Contractual and Financial Signing Authorities Document. Training courses will also be adapted to emphasize the channels-of-delivery.

The rationale for using a grant rather than a contribution was often unclear

5.48 The objective of the Treasury Board's Policy on Transfer Payments is to ensure sound management of, control over, and accountability for transfer payments. It requires departments to establish policies and procedures to ensure that proper program and other relevant documents are maintained to provide documentary evidence of decisions made.

5.49 Grants require less accountability than contributions (Exhibit 5.4). CIDA assumes a greater risk the recipient will not meet the goals of the program than it would if it used a contribution funding mechanism for the same initiative with the same recipient.

5.50 For the eight files that we looked at, we found that in most cases CIDA had not specified the reason for using a grant rather than a contribution. In our sample, we found that six of the eight recipients had received funding in the past. In all of these cases, CIDA had previously used contributions. One recipient had been receiving funding through contributions for about 20 years. In 2000, this recipient had, for the first time, received grant funding. We noted other cases involving recipients who had been receiving funding primarily through contributions until 2001, but who have since begun to receive grants. The files we examined did not contain an analysis of how the change in funding mechanism would affect expected results or the reasoning for using the grant mechanism. We recognize that the principles behind the

policy statement on strengthening aid effectiveness may favour greater use of grants than in the past. However, we still expect that the merits for using grants instead of other funding mechanisms and the effect on the expected result would be clearly evaluated and documented for each case. This is especially important as the grant mechanism does not impose any conditions on the recipient.

5.51 We are concerned that, without having assessed the probable effect on the expected development results, CIDA may be sacrificing a degree of control and oversight over how recipients spend CIDA funding.

5.52 **Recommendation.** The rationale for choosing a grant as the mechanism for funding a project should be documented and clearly explained in terms of the degree of desired control and the effect on the expected results.

CIDA's response. CIDA agrees with this recommendation and, by 1 February 2005, will develop criteria to determine when to use a grant or a contribution and the rationale for this choice in view of the need for appropriate controls and the effect on expected results. These will be incorporated into managerial guides and training courses on the management of grants and contributions.

CIDA has disbursed grant funds in advance of need

5.53 CIDA's Terms and Conditions for International Development Assistance state that the Agency should schedule instalment payments of grants to recipients according to their cash-flow requirements. However, exceptions are permitted. CIDA may pay grants in a single instalment in circumstances such as emergencies, or when required by Canada's overall foreign policy interests.

5.54 We found that for seven of the eight cases we looked at, CIDA had disbursed the entire grant as a single payment rather than in instalments. For six of those seven cases, we believe that CIDA could have disbursed the funds in instalments. In these six cases, CIDA had not demonstrated in its files its reasons for making an exception.

5.55 For example, CIDA advanced full payment of $2 million for a five-year membership in a newly established Advisory Centre on World Trade Organization Law because it had the funds available in that fiscal year. The entity's financial regulations allow for membership payments to be made in five, equal, annual instalments.

5.56 **Recommendation.** CIDA should respect the government's transfer payment policy and the Terms and Conditions for International Development Assistance when paying grants in a single instalment. The rationale for making an advance payment in a single instalment, which does not reflect the recipient's cash-flow needs, should be properly documented.

CIDA's response. CIDA agrees that all payments of grants should fully respect the Treasury Board Policy on Transfer Payments and the Terms and Conditions for International Development Assistance. To guard against the

possibility of payments exceeding the immediate cash flow requirements of grant recipients, financial staff assigned to program delivery branches will be required to sign off on each grant payment to ensure that it is consistent with the Treasury Board policy. Training courses will also be modified to emphasize Treasury Board policy.

CIDA is working to provide guidance on administering grants

5.57 CIDA recognized the need to develop material to guide staff in using and managing grants. In September 2003, the Contracting Management Division made available a draft copy of the Manager's Guide to CIDA Grants. This document discusses grant-related roles and responsibilities and provides information in areas such as using, approving, and managing grants. It also provides partial guidance on selecting a channel-of-delivery. CIDA staff told us that more work on the guide—including communication activities, developing a training course, and developing a grant template agreement—is in progress.

Financial compliance audits

5.58 In 1999 we examined the financial compliance audits that the Contract and Contribution Audit Unit had carried out on behalf of CIDA. In 2000 the Contract and Contribution Audit Unit was re-named the Financial Compliance Unit.

5.59 The main objective of these audits was—and continues to be—to make sure that all expenditures claimed by a Canadian executing agency are properly documented and comply with the terms and conditions of its agreement with CIDA. Financial Compliance Unit auditors identify possible ineligible expenses and refer them to CIDA staff for action (see Exhibit 5.6). Given the wide range of projects, the dollars involved, and the variety of documentation that supports recipient claims under the contract and contribution agreements, these audits are a key control for maintaining financial probity.

5.60 Our 1999 audit observed that the amounts identified as **audit adjustments** totalled $32.2 million or about three percent of the total value of expenditures claimed. The Contract and Contribution Audit Unit auditors

Exhibit 5.6 Terms CIDA uses in its financial compliance audits

CIDA uses certain terms relating to the results of financial compliance audits and how the organization deals with them.

Audit adjustment—an item that an auditor identifies as an ineligible expenditure, that is, an expenditure not supported by proper documentation or not allowed under the terms of an agreement.

Release—a decision resulting from further investigation and negotiation between CIDA and an executing agency, that an audit adjustment is an eligible expenditure, for which CIDA will pay.

Maintained adjustment—a decision that CIDA will not pay for an item because it does not comply with the agreement. Therefore, it represents an ineligible expenditure, which CIDA will recover from the executing agency.

had found persistent non-compliance problems and had identified a number of adjustments. We then looked at CIDA's **release** decisions to determine whether they had been justified and whether Canadian executing agencies had supported their claims with adequate documentation, such as proper receipts and other records.

5.61 We found that CIDA staff had released a high proportion of ineligible expenses that Canadian executing agencies had claimed, even though these agencies had not provided adequate documentation or other evidence to support their claims. We concluded that CIDA's releases were not always justified. We also found that certain standard clauses in the agreements were ambiguous. We noted that CIDA should clarify these clauses to reduce uncertainty and the risk of misinterpretation that could, in turn, lead to adjustments.

5.62 Since 1999, CIDA has acted on our recommendation to clarify key clauses in its agreements. The Contracting Management Division developed standard agreements for CIDA's geographic programs, and it is working to standardize all agreements across the Agency. The Financial Compliance Unit has also instituted the practice of initial visits; CIDA staff meet with Canadian executing agencies at the beginning of projects to clarify requirements for financial reporting and acceptable evidence to support a claim.

Justification for releases has improved since 1999, but problems persist

5.63 Despite these improvements, we noted a lack of independent oversight over the release of adjustments identified by financial compliance audits. The audit adjustments propose corrections for errors in payments to Canadian executing agencies that the project officer or program manager had previously approved under section 34 of the *Financial Administration Act*. Financial officers are involved in the internal discussions as to whether or not to release the adjustments, at times actively challenging the decisions made by the program staff. However, prior to the release of the adjustment, they provide no formal review or approval comparable to when they sign off under the *Financial Administration Act* for the initial payment. It is the program officer or manager who at this stage of the process again has the primary responsibility for making the final decision to release an audit adjustment. This decision is made after review and negotiation with the Canadian executing agency and in consultation with the Financial Compliance Unit, which plays an advisory role in the release process.

5.64 In 1999, only about 12 percent of CIDA's release decisions were justified and well-supported with documentation. Our follow-up examined a sample of 20 Financial Compliance Unit audit files (including 14 chosen statistically), from a total of 391 audits where CIDA had made a decision as to the release or maintenance of the proposed audit adjustments reported from 1 April 2000 to 30 September 2003. The follow-up showed that just fewer than 50 percent of the files that were reviewed showed proper justification and documentation for release decisions. Although this represents an improvement since 1999, our audit found that problems persist

with unjustified and/or inadequately documented releases of audit adjustments. Given our initial findings from 1999, we would have expected to see a more formalized role played by financial officers in approving the release of audit adjustments such as an independent sign-off for the release.

5.65 In this follow-up, we observed that, overall, the amounts identified as audit adjustments by financial audits initiated from April 2000 to September 2003 totalled $33.5 million or about three percent of expenditures claimed. CIDA officers released audit adjustments of $12.2 million, **maintained adjustments** of $9.1 million in ineligible expenditures, and had not yet made a decision on the remaining $12.2 million in audit adjustments. In our sample, we found a number of releases where claimed expenses clearly fell outside the terms of the agreements between CIDA and its Canadian executing agencies. By granting those releases, project officers and program managers allowed the claims. Section 34 of the *Financial Administration Act* requires that payments are made only for goods received and services rendered as per the contractual terms of the agreement. CIDA officers did not contravene section 34 of the *Financial Administration Act*. However, for a number of release decisions, CIDA ultimately did not ensure that it paid only for those goods received and services rendered according to the terms of the agreement. Accordingly, CIDA should have maintained these adjustments, amended the agreement, or sought appropriate authority for the release. CIDA has no clear guidelines for these situations, as to who may approve the releases or how appropriate authority should be exercised. Exhibit 5.7 provides examples of cases where project officers and/or program managers accepted expenditures that were outside the terms of the agreement.

5.66 We also noted that, in a number of cases, the rationale for the release was on file, but the documentation to support it was missing or inadequate. In our view, release decisions should be based on supporting evidence that is

Exhibit 5.7 Examples in which adjustments were released without assurance that goods and services were received as per agreement

Unauthorized releases by CIDA officers of audit adjustments for amounts that were outside the terms of the agreement	Inadequate documentation to support release decisions
Two audit adjustments were released for reimbursable costs claimed by a Canadian executing agency for its contractors, at the higher rates applying to its employees. An audit adjustment was released for salaries claimed separately by a Canadian executing agency. These costs were already included in an overhead allowance provided under the agreement. An adjustment for overtime costs that were in excess of the salary budget allowed in the agreement was released.	An adjustment for a travel advance claimed was released based solely on a financial statement submitted by the Canadian executing agency that did not indicate whether the advance had been spent. An adjustment relating to salaries paid for work on statutory holidays and annual vacation was released without proof that the employees were present on those days.

commensurate to that required by the Financial Compliance Unit auditors during the initial audit. Releasing an adjustment without sound, well-documented reasons and without supporting evidence means that CIDA may be paying for unauthorized items. Examples of poor documentation to support the release decision are shown in Exhibit 5.7.

5.67 A cutback made in the number of planned Financial Compliance Unit audits may weaken this important control over expenditures. In October 2000, CIDA's Management Committee made it mandatory that all agreements of more than $3 million be audited after the first year of operation. CIDA expected that the audits would identify any emerging contractual and administrative problems more quickly. However, for budgetary reasons, CIDA dropped these audits, along with random reviews, from the Financial Compliance Unit's audit plan for 2003–04, although both were important elements in CIDA's risk-based audit framework. We also noted that the number of financial compliance audits planned for the 2003–04 year had been substantially reduced. This reduction contrasted sharply with the trend that had occurred over the previous four years toward more audit coverage. We are concerned that CIDA's cutbacks in the work done by the Financial Compliance Unit may result in less compliance with agreements by Canadian executing agencies and fewer recoveries of overpayments.

5.68 As we said in 1999, compliance audits are an important financial control, and CIDA needs to be more insistent about maintaining adjustments and about challenging Canadian executing agencies with respect to expenditures that do not comply with their agreements. This audit indicates that despite some improvement, CIDA's current practices for dealing with audit adjustments need strengthening.

5.69 **Recommendation.** CIDA should ensure that every release is properly and independently authorized and that adequate supporting documentation is on file to justify the release.

CIDA's response. CIDA agrees with this recommendation. Accordingly, by 1 February 2005, the Agency will require that the Finance Division's Financial Compliance Unit formally sign off on each audit adjustment that is to be released. A condition of this sign-off will be that adequate documentation supporting a release be available on file.

While CIDA's financial situation in 2003–04 necessitated budget reductions in most of the Agency's operations, including the Financial Compliance Unit, the budget of the Unit was completely restored at the outset of 2004–05. The reinstatement of funding underscores the Agency's commitment to ensuring the effectiveness of the Financial Compliance Unit.

Counterpart funds

5.70 In two previous reports (1998 and 2000) we raised concerns about CIDA's control over counterpart funds. Exhibit 5.8 explains the basics of the counterpart fund concept.

5.71 We raised concerns in 1998 about the need to revise or update the policy and guidelines for managing counterpart funds, particularly with

respect to dealing with cases in which products had not been fully monetized. CIDA agreed to strengthen its procedures in this area.

5.72 In our October 2000 audit of CIDA, we again noted monetization gaps, that is, where recipient countries had not deposited the full amount of money owed to their counterpart funds even though they had agreed to do so. CIDA agreed to scrutinize funds more consistently and "take appropriate action where needed."

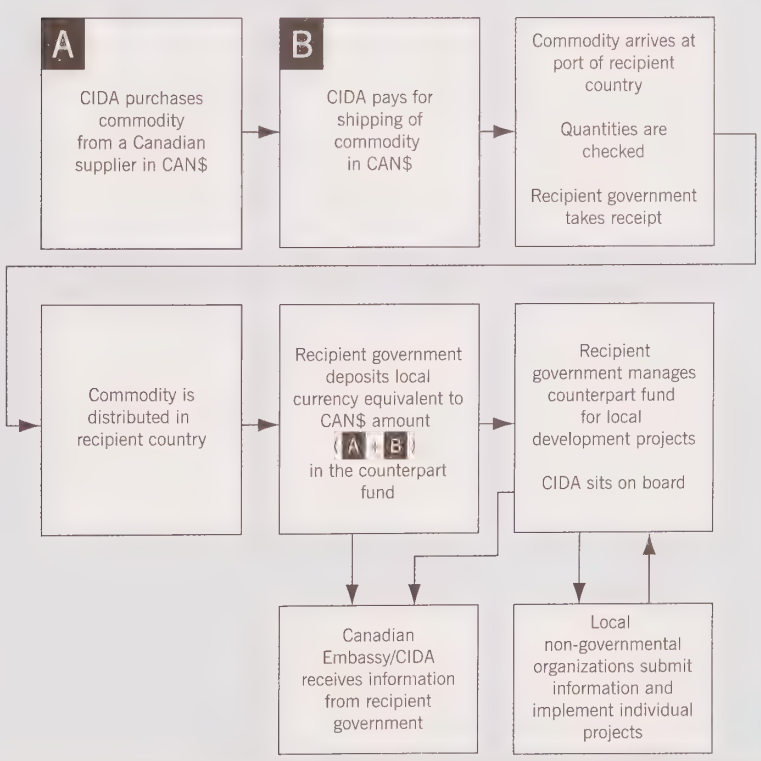
Exhibit 5.8 Counterpart funds and monetization

Counterpart funds are well-established funding mechanisms that enable CIDA to convert Canadian goods into funding for locally-managed aid projects.

Under counterpart funding, CIDA buys a commodity (for example, wheat) from a Canadian supplier. When the recipient government or a local purchaser takes possession of the product, the government must then deposit into a counterpart fund an amount of local currency equivalent to what CIDA originally paid the Canadian supplier for the product, plus shipping costs. In doing so, the recipient government is monetizing that commodity. Where a government deposits the full equivalent amount, the commodity is considered fully monetized. In some cases, CIDA allows the recipient government to deduct a small amount for its administration costs.

The fund, known as a counterpart fund, is used by the recipient government to finance local development projects. CIDA often has representation on the board of directors of the fund.

Typical operation for a counterpart fund



Source: CIDA and our reports.

5.73 CIDA has not yet updated its 1994 policy and guidelines for managing counterpart funds, although in 1998, 2000, and again in 2003, it made commitments that it would update its Counterpart Fund Policy. The Agency noted that the revised, updated policy would address the issues of accountability and management raised by the Office of the Auditor General and internal CIDA audits. As of October 2004, the new Policy and Guidelines for the Management of Counterpart Funds remained in draft form.

5.74 We noted that CIDA's Internal Audit directorate has not audited any counterpart funds since 1998. Nor has it done any follow-up to determine what the Agency has done to respond to problems noted in two of its previous audits of counterpart funds. Internal audit staff told us that they have been waiting for a new counterpart fund policy before undertaking more work on these funds.

5.75 The 1994 counterpart fund policy requires program managers to submit brief annual reports to CIDA's Policy Branch on the counterpart funds for which they are responsible. The purpose of these reports was to enable the Agency to centrally collect data on counterpart funds. We found that managers have not submitted these reports as required. The branch had not received any of these reports in three years. In our view, the lack of current and adequate information compromises the Agency's ability to monitor counterpart funds properly and to account for their results.

Monetization gaps were minor

5.76 In 2000, we found two out of six funds, for which the recipient countries had deposited less than 100 percent of the monetized value of commodities, contrary to CIDA policy. We again examined six funds for the follow-up. CIDA was unable to produce documentation that should have been on its files relating to the fund that operated in Haiti. The situation in Haiti prevented CIDA from reconstructing the documentation from other sources. We were thus unable to determine if and when the funds were deposited for that counterpart fund. For the remaining five funds audited, other than minor variances relating to exchange rates, we found that full equivalent value had been deposited in accordance with CIDA policy. For two of the remaining five funds, we could not determine whether the countries had deposited the money according to the agreed-upon schedule because CIDA could not provide us with the necessary information (Exhibit 5.9).

5.77 With respect to the funds in Mali and Bangladesh, the exchange rate that those governments used to determine how much to deposit into the counterpart fund differed from the rate we obtained from an independent source. The differences in rates for Mali translated into potentially 2.7 percent less of the value of purchases from Canadian suppliers (about $380,000 out of $13.8 million). For Bangladesh, the differences translated into potentially 1.3 percent less than the value of purchases from Canadian suppliers (about $560,000 out of $43.2 million). We could find no evidence on file that CIDA had verified that the exchange rates used for monetization were acceptable.

Exhibit 5.9 **Problems with monetization for projects we examined**

Counterpart fund/finding	Deposit less than 100% value	Potential deposit differential due to exchange rates used	Timing of deposits
Haiti	No documented evidence available	No documentation available	No documentation available
Mali	No problem noted	About $380,000 less	Unable to determine exact date of deposits from documentation on file
Bangladesh	Deposited at less than full value, but justified as per CIDA policy requirements	About $560,000 less	No problem noted
Mauritania	No problem noted	No problem noted	Unable to determine exact date of deposits from documentation on file
Philippines	No problem noted	No problem noted	No problem noted
Cambodia	No problem noted	No problem noted	No problem noted

5.78 In our view, the CIDA managers responsible for the monetization of the funds where problems were noted did not demonstrate sufficient vigilance in implementing CIDA policy.

5.79 **Recommendation.** CIDA should update its policy on the monetization of counterpart funds without delay. The new policy should make clear the acceptable boundaries for monetization and address issues such as exchange rates and the required timing of deposits.

CIDA's response. CIDA's draft counterpart fund policy update is currently scheduled to be presented to the Policy Committee for approval before 1 February 2005.

The draft policy indicates that CIDA must justify the percentage of the value of goods and services provided in Canadian dollars that is to be collected in local or foreign currency. It also stipulates that the bilateral arrangement between CIDA and the recipient government must define, among other things, how to determine the exchange rate between the value of the goods or services in Canadian dollars and in local or foreign currency, as well as the timing of deposits of local or foreign currency into the Counterpart Fund account.

Conclusion

5.80 The results of this follow-up audit indicate that CIDA has made satisfactory progress on the key issues we raised in previous years, such as the use of sole-source contracting, monetization of counterpart funds, clarification of key clauses in agreements to reduce ambiguity, and monitoring of project risks. While some areas still need attention, overall, CIDA has made satisfactory progress on our recommendations.

5.81 CIDA has made efforts to provide direction on the appropriate use of sole-source contributions and contracts. We found that as a result, the unjustified use of sole-source agreements diminished significantly. CIDA needs to make further efforts to ensure that the spirit and the letter of its own and government policies are being respected.

5.82 CIDA has improved its project management by including clauses in agreements to make Canadian executing agencies more responsible for the sustainability of project benefits. The Agency has also improved its risk management of projects.

5.83 CIDA conducts a number of audits to ensure that Canadian executing agencies comply with the terms and conditions of the contract and contribution agreements. Those audits recommend the recovery of unjustified or improperly documented amounts that CIDA has paid. Frequently, CIDA decides to release the Canadian executing agency from the requirement to repay some of those amounts. CIDA has clarified its standard agreement and shown some improvement in documenting and justifying those release decisions. However, we are concerned that in the files we audited, half of those release decisions made were still unjustified or not properly documented. In these cases, we believe that CIDA is in effect deciding to pay for items where it is not apparent that the goods were received or the services rendered according to the terms of the agreement.

5.84 For counterpart funds, CIDA has shown substantial improvement in this area as the problems we found were minor compared to those found in the previous audits.

5.85 During the course of our audit, we observed that CIDA is increasingly using grants as a funding mechanism. We note there are cases of CIDA using grants where it formerly used contributions to fund projects. While the use of grants is consistent with CIDA's recent approach to partnering with other donors, for the cases we audited, the rationale—in terms of obtaining better developmental results—was not on file for using a grant rather than a contribution. In addition, CIDA had not properly justified disbursing grants in advance of need.

About the Follow-Up

Objectives

The primary objective of this follow-up was to assess what CIDA has done to address issues and recommendations that were raised in two of our previous reports: Chapter 28 of the November 1999 Report and Chapter 14 of the October 2000 Report.

Scope and approach

The follow-up focussed on four main areas addressed in our previous chapters:

- **Contractor selection.** Our examination focussed on the process for selecting contracts, contribution agreements, and grant agreements related to aid projects. Using a risk-based approach, we selected for audit non-statistical samples of 5 non-competitive contracts, 19 contribution agreements, and 8 grant agreements. Our samples were chosen from aid agreements that were over $100,000 in value and that had been entered into between January 2001 and August 2003. During this period, those agreements included over 40 non-competitive contracts totalling about $110 million, over 1,400 contribution agreements totalling about $2.1 billion, and 755 grant agreements worth about $1.6 billion.
- **Non-compliance with contracts and contribution agreements—Financial Compliance Unit.** We looked at how CIDA had dealt with the results of financial compliance audits. Overall, the amounts identified as audit adjustments by financial audits initiated from April 2000 to September 2003 totalled $33.5 million or about three percent of expenditures claimed. We reviewed a sample of 20 audit files chosen from 391 financial compliance audits initiated between 1 April 2000 and 30 September 2003 for which a decision about the release or maintenance of the proposed audit adjustments had been made by CIDA. These included a statistical sample of 14, chosen through the use of the statistical Chi-squared sampling methodology, in order to evaluate whether or not CIDA had improved its documentation and justification of release decisions since our previous audit.
- **Controls over payments into counterpart funds.** We examined and assessed six out of approximately 23 counterpart funds (including some for which we had reported problems in 1998 and 2000) to determine what CIDA had done to strengthen financial management controls over counterpart funds.
- **Implementation of agreements.** The 2000 audit raised a number of issues around how well contracts and contribution agreements had been executed. In our follow-up field visits, we examined CIDA's and the executing agency's processes for managing project risks and critical assumptions, for ensuring project sustainability, and for terminating projects. We examined and made visits to 10 projects in the Philippines, Egypt, and Cuba.

From the 1999 report, we followed up on the following:

- **The results of audits.** Whether or not CIDA had clarified standard contract clauses to reduce ambiguity, and whether CIDA maintained audit adjustments unless the recovery of the unauthorized expenses was clearly not cost-effective.
- **The role of performance review.** Whether or not the Performance Review Branch (now the Performance and Knowledge Management Branch) had periodically assessed the Financial Compliance Unit audits of contracts and contributions to determine whether they are providing the required level of financial control.

Areas we did not follow up on were

- project financial controls, and
- the role of performance review in auditing the quality and accuracy of information reports by Canadian executing agencies.

From the 2000 report, we followed up on the following:

- **Agreement planning and design.** Provisions for sustainability.

- **Selection.** The use of non-competitive contribution agreements instead of competitive agreements, and the use of sole-sourced contracts.
- **Execution of agreements.** Controls over payments into counterpart funds, management of the assumptions deemed critical to project success, and building off-ramp provisions into agreements.

Areas we did not follow up on were

- the realism of the planned and expected project results, and
- Canadian Partnership Branch agreements.

Additional areas audited that relate to the issue areas followed up include the increased use of grant agreements for aid projects, CIDA's analysis of the value and existence of in-kind contributions by recipients of its contributions and the restriction that there be no profit, and the application of section 34 of the *Financial Administration Act* when dealing with audit adjustments.

We conducted our work at CIDA's headquarters and visited selected projects in the field. We reviewed project documentation and interviewed Canadian executing agencies and CIDA officials. We also reviewed CIDA status reports on how it has responded to our recommendations.

Criteria

The audit criteria from the 1999 and 2000 chapters remain relevant and were largely derived from CIDA's internal guidelines and from Treasury Board policies. We therefore expected to find the following:

- Treasury Board directives (including the Terms and Conditions for International Development Assistance and the associated Framework Policy approved by Treasury Board in 2001), Government Contracts Regulations, and CIDA internal policies should be respected.
- The contracting plan should contain an analysis of different options for the particular project, with competition being the norm.
- Contract and contribution performance should be monitored and evaluated against the terms and conditions of the agreement.
- Decisions to release financial compliance audit adjustments should be appropriately supported and taken at the proper decision-making level.
- Issues identified in audit reports should be analyzed, and corrective action taken as needed.
- Decisions to recover or write off amounts owed to CIDA should be documented and taken by the appropriate decision-making authority.

We also expected CIDA to have carried out the actions it had indicated it would take in response to previous observations and recommendations from our 1999 and 2000 reports.

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Chapter

6

Canadian Nuclear Safety Commission

Power Reactor Regulation

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canadian Nuclear Safety Commission
Power Reactor Regulation

Main Points

6.1 Overall, the Canadian Nuclear Safety Commission (CNSC) has made satisfactory progress in response to our recommendations from our December 2000 audit of power reactor regulation. However, progress has been slower than planned in developing a formal, well-articulated risk-management approach to power reactor regulation.

6.2 In response to that audit, CNSC posted an action plan on its Web site and updated it regularly. The action plan called for it to have a risk-based approach in place by the end of 2003. It is implementing a systematic, risk-informed regulatory approach to its activities for the regulation of nuclear substances and uranium mining and processing. However, the CNSC has only recently launched a program to develop a plan by March 2005 that, when implemented, will adopt this approach in its regulation of power reactors.

6.3 The CNSC has made satisfactory progress in implementing a consistent approach to compliance and enforcement within and across the divisions that plan and conduct compliance inspections of power reactors.

6.4 Since our 2000 audit, the CNSC has developed a new scale for rating the performance of power reactor licensees in meeting CNSC's regulatory expectations and has issued key regulatory documents. It has also implemented a process for assigning priorities among regulatory policies, standards, and guides to be developed. It has made satisfactory progress in addressing the human resources issues of capacity, recruitment, and retention of capable staff, and clarification of roles and responsibilities.

Background and other observations

6.5 The CNSC regulates the use of nuclear energy and materials to protect health, safety, the environment, and national security. Since our December 2000 audit, two events occurred that had a significant impact on the CNSC and underscore the importance of its role. The first event was the terrorist attacks on the New York World Trade Centre on September 11, 2001; this prompted an immediate re-evaluation of the security measures at Canada's nuclear facilities, and additional measures were implemented to improve security.

6.6 The second event was the power outage of 14 August 2003 that affected Ontario and the eastern United States. The CNSC participated in a Canada-U.S. joint task force that investigated the cause of the outage. The task force concluded that the nuclear power plants had not triggered or

spread the power system outage and were maintained in a safe, shutdown condition until their restart.

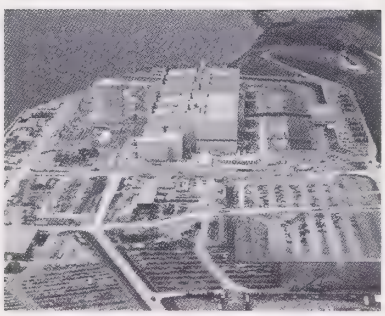
6.7 After reviewing the structure of comparable regulatory organizations, the CNSC decided not to separate the role of CEO from that of chair of the Commission. It restructured the organization along business lines and clarified the roles of chair of the Commission and chief executive officer.

The Canadian Nuclear Safety Commission has responded. The Canadian Nuclear Safety Commission has responded to our observations and informs us that it is continuing with the improvements it began in response to our December 2000 recommendations.

Introduction

6.8 The *Nuclear Safety and Control Act* came into force on 31 May 2000, creating the Canadian Nuclear Safety Commission (CNSC) to replace the Atomic Energy Control Board. Like its predecessor, the CNSC is responsible for regulating the use of nuclear energy and materials in Canada to protect health, safety, security, and the environment. This includes the licensing and regulation of power reactors, the subject of an audit we reported in December 2000.

6.9 The Canadian Nuclear Safety Commission is a technically oriented organization that includes an operational staff component (CNSC) and an independent tribunal component (Commission). The operational component consists of more than 570 staff who conduct audits and inspections of licensed nuclear facilities. They also carry out detailed reviews of licence applications. On the basis of those reviews, the staff make recommendations to the Commission comprising up to seven government-appointed members chaired by the President of the CNSC, which makes the final licensing decisions for nuclear-related activities in Canada.



Darlington Nuclear Generating Station

6.10 In its fiscal year 1999–2000, the CNSC employed 440 staff and its costs totalled $59 million. Its headquarters are in Ottawa, and it maintains a site project office at each of the five nuclear generating stations, where its staff monitor the licensee's compliance with regulations and with the licence conditions. Canada has 22 power reactors: 20 in Ontario, 1 in Quebec, and 1 in New Brunswick. At the time of the follow-up audit discussed in this chapter, the CNSC had about 510 staff; its total budget for the fiscal year 2003–04 was $76 million.

6.11 The activities of licensing and regulating power reactors account for nearly half of the CNSC's resources and represents its most significant responsibilities, given the risks to public health and safety should a major accident occur.

6.12 In its Annual Report for 2001–02, the CNSC highlighted the work it had undertaken in the aftermath of the September 11 terrorist attacks in the United States. Immediately following those events, it had conducted a comprehensive re-evaluation of security measures in place at nuclear facilities. Additional measures were implemented to increase security at Canada's nuclear generating stations and other facilities. The CNSC reported that it would continue investigating possible security measures to ensure the continued safety of Canadians.

6.13 In its Annual Report for 2003–04, the CNSC referred to the power outage of 14 August 2003 that affected Ontario and the eastern United States. A Canada-U.S. joint task force concluded that the nuclear power plants in both countries had not triggered the power outage or its spread. The task force's Nuclear Working Group also concluded that safety functions had been effective and the affected nuclear power plants had been maintained in safe, shutdown conditions until their restart.

Focus of the follow-up

6.14 In December 2000 we reported that the Canadian Nuclear Safety Commission needed to improve its regulatory regime to ensure that it continued to protect the health and safety of Canadians (December 2000 Report, Chapter 27, Canadian Nuclear Safety Commission—Power Reactor Regulation). Following the tabling of our chapter, the House of Commons Standing Committee on Public Accounts (PAC) held a hearing and issued its Seventeenth Report. Its recommendations further supported our observations and recommendations. In response to our audit, reinforced by the PAC report, CNSC posted its action plan, to address the recommendations on power reactor regulation, on its Web site and updated it regularly. In fact, it concluded that the recommendations also applied to other activities, and it undertook to implement the recommended changes across the CNSC, including activities in the regulation of nuclear substances and uranium mining and processing.

6.15 The objective of our follow-up audit was to determine the extent of CNSC's progress on implementing our recommendations to improve its regulatory regime for power reactors. We also wanted to determine its progress on implementing the recommendations in its other service lines: Nuclear Substance Regulation and Nuclear Cycle and Facilities Regulation. We did not examine the security aspect of CNSC's responsibilities. The scope and criteria for this follow-up audit are outlined at the end of the chapter in **About the Follow-Up**.

Observations

Organizational changes since 2000

6.16 Since our December 2000 audit, the CNSC has made organizational changes to improve decision making. The Executive Vice-President of Operations is now accountable for five directorates—the three regulatory service lines (power reactors, nuclear substances, and uranium mines and facilities), an assessment and analysis group, and a regulatory documents and program improvement group (Exhibit 6.1).

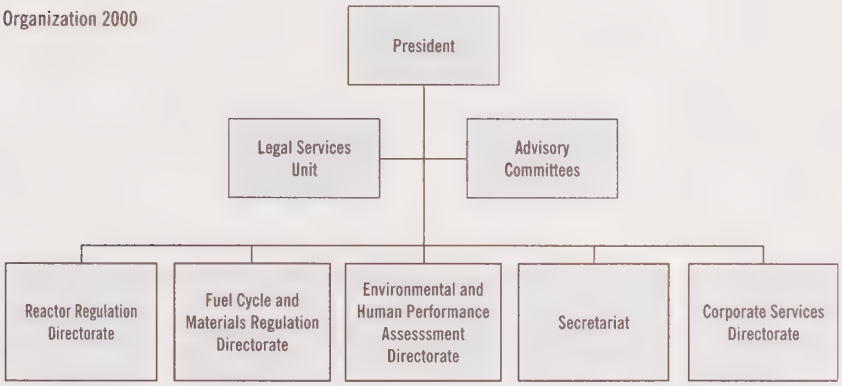
6.17 The CNSC also formed a secretariat that is separate from the operational staff groups and that provides support to the Commission members. The Commission Secretary heads the secretariat and has a mandate to maintain the separation between the CNSC operations staff and the Commission members. The changes to the organization have improved CNSC's operations and provided separation between the operations and support functions of the CNSC and the Commission.

6.18 The CNSC also developed a revised program to recover its costs, with new fees regulations, which became effective in July 2003. The new regulations are intended to make the financing of CNSC programs more equitable, in that licensees pay all or part of the costs of regulatory activities. The new fee structure requires the CNSC to inform licensees about its

planned regulatory activities, the costs of those activities, and the applicable fees, before each fiscal year when the fees are to take effect. This will impose greater discipline on regulatory activities and move the CNSC toward a more risk-based approach to regulation. With fees based largely on planned work activities, licensees will expect the CNSC to demonstrate that it is directing its resources to licensing and compliance activities in areas of higher risk and priority.

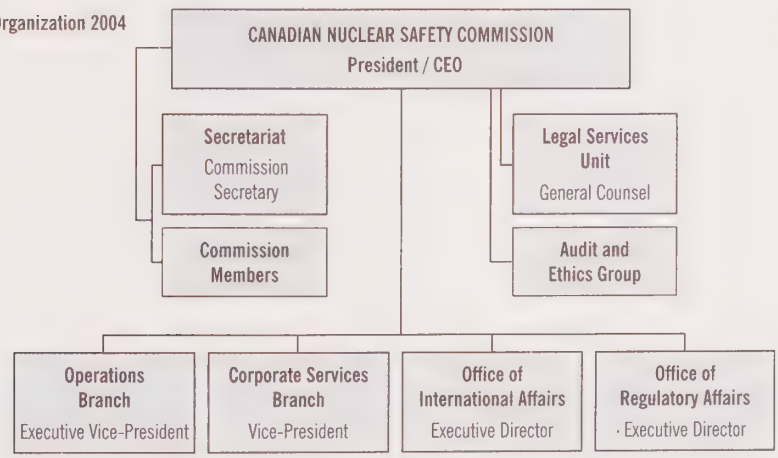
Exhibit 6.1 CNSC organization in 2000 and 2004

Organization 2000



Source: CNSC Annual Report 2000-01

Organization 2004



Source: CNSC Annual Report 2003-04

Risk assessment and performance reporting

6.19 In 2000 we reported that

- the CNSC's regulatory activities were not based on a rigorous, well-documented system of risk analysis; and
- its ratings of the safety performance of licensees were not clear and understandable to all stakeholders.

6.20 CNSC staff assess the programs and performance of each licensee in meeting its regulatory expectations. CNSC refers to this as safety performance. It covers nine areas: operating performance, design adequacy, equipment fitness for service, emergency preparedness, environmental performance, radiation protection, nuclear security, safeguards, and performance assurance.

Implementing a systematic, risk-informed approach to regulatory activities

6.21 In 2000 we expected that the CNSC would base its regulatory activities on an analysis of relevant risks, the results of previous regulatory activities, and a rigorous, well-documented process linking activities to required results. A few CNSC divisions had developed formal approaches to risk analysis as a basis for proposing regulatory activity. Divisions involved in regulation of power reactors, however, had used an intuitive approach, relying on the judgment and expertise of staff. Safety performance indicators were not yet applied along with judgment and expertise in any systematic, integrated way to determine the nature or level of the work to be done. Without this type of analysis, the CNSC could not demonstrate whether it was doing enough or too much work in any area and whether it was overstaffed or understaffed.

6.22 In this follow-up audit we found that the Operations Branch had decided to implement an integrated, risk-informed approach to regulatory activities in phases, by branch service line. It started with the regulation of nuclear substances, then the regulation of uranium mining and processing. The next phase is to apply the approach to power reactor regulation; the final phase will integrate the allocation of resources on a risk-informed basis across the Operations Branch.

Satisfactory progress in regulating activities for nuclear substances and uranium mining and processing

6.23 **Nuclear substances.** The Directorate of Nuclear Substance Regulation conducts licensing and compliance activities for about 3,500 licences, classified into 90 types of use. These licences cover nuclear substances such as radioisotopes for medical uses and radiation devices widely used in research and industry. The Directorate has developed and is implementing a systematic approach that ranks risks and assigns priority and resources according to risk level. The risk management program for the Directorate is to be implemented over several years.

6.24 The 90 use-types were ranked in three distinct risk groups. Based on their safety performance, licensees were assigned to a risk group. The ranking is used to determine the levels of effort and resources needed to manage licensing and compliance activities, which include verification, enforcement, and promotion of licensees to a better ranking. Based on rankings, the Directorate has established the levels of resources and effort needed in compliance inspection activities for all use-types.

6.25 **Uranium mining and processing.** The Directorate of Nuclear Cycle and Facilities Regulation developed a systematic, risk-informed process to help managers decide where to allocate resources. It used a series of internal

workshops and extensive consultation with facility and subject matter experts in the Operations Branch to rank the licensed facilities.

6.26 The Directorate then recommended that regulatory effort be allocated to each facility's licensing cycle based on the facility's ranking. The recommendations will serve as a guide for the licensing and technical specialists to decide on the appropriate regulatory activities for each licensee. Using this structured approach in the planning of regulatory effort should improve the allocation of resources within the Directorate.

Developing a plan to improve power reactor regulation

6.27 Project officers and technical specialists together assess each nuclear facility to obtain assurance that the level of risk to health, safety, and the environment remains within the terms of the facility's licence. Specialists review documentation and conduct audits to assess the quality and reliability of key reactor components as well as the facility's safety analysis, radiation protection, operating performance, safety procedures, and management. The review is linked to the licence-renewal cycle and is intended to cover all of the CNSC's regulatory requirements for the facility.

6.28 In January 2004, the CNSC announced appointments in the Operations Branch to address the need for an effective and efficient, risk-based program for the regulation of power reactors. In May 2004 it established the Power Reactor Regulation Improvement Program to examine all aspects of regulation and establish a plan for improvement. The plan, when implemented, will base levels of regulatory activity on a formal, well-articulated approach to risk management. Six teams of directors were formed to propose plans for improvements in key areas:

- Planning and reporting
- Process management—compliance
- Process management—licensing
- Risk-informed approach
- Information management and communication
- Leadership/management and human resources

6.29 The teams began meeting in June 2004 to confirm areas for assessment. Proposals for areas for improvements were reviewed in September; an improvement plan is to be prepared by March 2005.

6.30 Although recent developments are encouraging, the original action plan posted by the CNSC on its Web site indicated that a risk-based approach would be implemented by the end of 2003. We are concerned about the slow progress and the absence of an approved plan setting out the approach, resources, accountabilities, deliverables, and timelines for developing a systematic, risk-informed approach to allocating the appropriate regulatory effort for each power reactor.

No formal plan for integration across the Operations Branch

6.31 The CNSC intends to ultimately integrate the risk-informed approach to regulatory activities for all its service lines to support a broad range of management decisions across the Operations Branch. In October 2002, the target date to complete this integration was December 2003. Achieving an integrated approach across the Operations Branch will depend on the success of improvements in the regulation of power reactors.

6.32 One of the working groups on the Power Reactor Regulation Improvement Program is developing guidance on risk management for regulatory activities across the Branch. This guidance will form part of the improvement plan to be in place by March 2005 that will include desired results, milestones, and accountabilities.

New safety performance ratings have improved communication with licensees

6.33 Assessing licensees' safety performance against the CNSC's requirements and expectations is an important element of the licensing process. The CNSC's staff rate performance against the requirements set out in the *Nuclear Safety and Control Act* and the expectations outlined in regulatory documents. Safety performance ratings of power reactor licensees are included as "report cards" in Commission members' documents for review at public hearings when licences are being renewed or reviewed. In addition, performance ratings are presented annually in the Annual Report on the Canadian Nuclear Power Industry, which is discussed at a Commission meeting and posted on the CNSC's Web site.

6.34 In 2000 we noted that in its licensing reports the CNSC assessed and categorized various aspects of performance as acceptable, conditionally acceptable, or unacceptable. However, it arrived at those ratings using criteria that were subjective. For example, "conditionally acceptable" did not convey whether and to what degree the licensee was managing safety properly and whether the licensee's action plans and progress were satisfactory. This lack of clarity contributed to uncertainty and misunderstanding about the adequacy of the licensee's safety performance.

6.35 In 2002 the CNSC introduced a new system for rating the safety performance of nuclear power plants. In the nine safety areas previously discussed, staff assess licensees' programs and their implementation according to five ratings:

- A—Exceeds requirements (consistently exceeds applicable CNSC requirements and expectations)
- B—Meets requirements (meets the intent or objectives of CNSC requirements and expectations)
- C—Below requirements (performance below requirements; improvement needed)
- D—Significantly below requirements (continued poor performance; corrective action required)

- E—Unacceptable (breakdown or loss of control; more stringent enforcement action required)

6.36 Whether the CNSC is conducting a site inspection or a comprehensive review, each assessment requires a performance rating. The ratings for each licensee are accumulated and become part of the overall ranking of its performance in each safety-related area.

6.37 The new rating scale has improved the clarity, transparency, and consistency of performance ratings to licensees, CNSC staff, and the public. Although it is a substantial improvement over the previous system, further refinements are needed to improve communication between the CNSC and licensees.

6.38 For example, some licensees do not have a clear understanding of the rating scale and how to move up the scale to a better rating. In January 2004, they asked the CNSC to clarify the basis for the ratings they had been given and to explain what improvements were needed to achieve better ratings. The CNSC met with those licensees in summer 2004 to respond to their concerns.

Compliance and enforcement

6.39 In 2000 we reported that the compliance and enforcement system had not been applied consistently across the CNSC and further work was needed to develop a more results-based and systematic approach. The CNSC needs regulatory documents, including policies, standards, and guides, to clearly explain its regulatory requirements to staff, licensees, and the public. The documents were either incomplete or had not been revised after the *Nuclear Safety and Control Act* went into effect.

Satisfactory progress on an integrated approach to compliance inspections

6.40 In December 2000 we noted that in response to internal audit recommendations, the CNSC had approved a compliance program policy and had developed a plan to implement it consistently across the CNSC. Compliance and enforcement programs were to identify regulatory requirements and communicate them to licensees; compliance and enforcement actions were to be applied consistently and effectively throughout the organization. According to the CNSC, this would lead to a more results-based, systematic approach, taking into account a licensee's past compliance history when deciding whether to increase or decrease the level of scrutiny in regulatory activities.

6.41 In 2003, the CNSC's Compliance and Licensing Director at one nuclear power facility initiated quarterly meetings for representatives of all divisions participating in inspections and audits at the facility. This initiative was a successful pilot project for co-ordinating work and communicating well across the licensing group and technical groups. Based on the favourable results of the pilot project, the Power Reactor Regulation Directorate established a requirement that all compliance and licensing divisions conduct similar quarterly meetings.

6.42 In our follow-up we found that the Operations Branch has made considerable progress toward defining a consistent compliance program for power reactors. It had compliance and licensing divisions meet quarterly to co-ordinate inspection plans for each site, and it assigned to division directors the responsibility for managing the inspection programs at their stations. As part of the new cost-recovery program, division directors explained 2003 year-end variances in their inspection programs with licensees. CNSC has informed us that it intends to continue this practice annually. In addition, directors of compliance and licensing divisions have started using consistent planning tools to identify significant issues at facility sites, and they formally take account of the facilities' past performance in shaping their compliance programs. In September 2004, the compliance and licensing divisions and other participating divisions met for the first time to review compliance and inspection programs across nuclear power stations.

6.43 The Power Reactor Regulation Improvement Plan is intended to contribute further to the compliance inspection programs by clarifying roles and responsibilities between divisions, developing a plan for documenting a risk-based approach to resource allocation, and resolving the inconsistencies that remain in the management of inspection programs.

Key documents published and system implemented for prioritizing others

6.44 The *Nuclear Safety and Control Act* was passed in 1997 and came into force on 31 May 2000. In December 2000 we reported that the CNSC had revised or developed only some of the regulatory documents that were needed to make the regulatory system transparent and effective, which would provide staff and licensees with a clear understanding of the regulatory requirements, the processes for monitoring compliance, and the rules of enforcement.

6.45 In April 2003, the CNSC formed the Regulatory Documents Steering Committee, comprising one director from each of the five Operations Branch directorates responsible for the service lines and technical lines. The Committee sets priorities for developing regulatory documents, and it monitors the production of documents in accordance with the approved process.

6.46 The CNSC has clarified the definitions of the types of regulatory documents, which include policies, standards, guides, and notices. It has published about 20 key regulatory documents; another 15 have undergone public consultation; and 10 are currently open for consultation. The Steering Committee has developed a list of 31 other high-priority documents. The purpose and scope statements for all of the remaining high-priority documents are nearing finalization.

6.47 These steps represent satisfactory progress since our audit in 2000.

6.48 In the past, the CNSC was inclined to develop its own regulatory documents rather than draw on the safety standards of other agencies, such as the International Atomic Energy Agency. In 2003 the CNSC informed the Agency that it intended to adopt or adapt existing documents in order to harmonize its regulations with world-wide standards.

Human resources management

Satisfactory progress on addressing human resources capacity

6.49 In 2000, we reported that the CNSC faced difficulties in recruiting and retaining scientific and technical staff. In May 2000, many positions in the organization were vacant—some of them key positions.

6.50 In addition to staff shortages, the CNSC, with its aging employee population, was facing a loss not only of leadership but also of high-level expertise in the nuclear industry, which had been acquired over many years.

6.51 Since our audit, the CNSC has strengthened its human resources capacity. It established an internship program for power reactor regulation in 2001 to hire university graduates. All eight candidates completed their two-year rotation assignments, and all accepted positions in the organization. Another group of interns started in 2003, and a third group started in 2004. CNSC plans to recruit new candidates for the internship program annually. One important aspect of the program is the placement and retention of interns as permanent employees. To date, CNSC has successfully retained them all. CNSC informed us that it recognizes that recruitment and retention of qualified staff is an ongoing challenge.

6.52 As a result of changes in the nuclear power industry and other fields of technology, well-qualified and experienced candidates became available for positions with the CNSC. The vacancy rate in the Power Reactor Regulation service line was at eight percent in 2000; by 2003 almost all of the vacant positions had been filled. Further, management was confident of attracting capable trainees and experienced candidates at more senior levels.

6.53 Although the CNSC has experienced a high level of turnover at the senior management and technical levels since 2000, through retirements and departures, the impact on the organization has been less than expected. This is due partly to the development of new regulations and a more structured management as well as the recruitment programs.

6.54 In 2001 the Human Resources Directorate developed a workforce sustainability strategy. This strategy recognized the aging of the workforce and the importance of ensuring that the CNSC had the technical and management talent it needed. At the time of our follow-up audit, the Directorate had numerous recruitment and retention initiatives planned and underway to address these issues.

A need to clarify accountability for communications with licensees

6.55 In 2000, the respective roles and accountabilities of the site project offices and the technical specialists at headquarters were not clearly defined and understood. For example, staff at site project offices were not certain who was responsible for taking the lead on specific issues, so the lead role was often assumed on an ad hoc basis. In the absence of a clear understanding and effective implementation of the centralized approach to planning and reporting, accountability was fragmented. It was difficult to reach consensus on the safety performance of each nuclear facility.

6.56 In our follow-up, we found that the respective roles and responsibilities of the CNSC's site project offices and its headquarters were more clearly defined and understood, due in large part to the restructuring of the organization in 2002. At that time, the Operations Branch assigned to each nuclear power facility a compliance and licensing director responsible for managing inspection activities at the site and related issues at headquarters in Ottawa. This has helped staff at both the site project offices and headquarters gain a clearer understanding of their respective roles and responsibilities.

6.57 The Power Reactor Regulation Improvement Program has several initiatives intended to strengthen the management of regulatory activities—for example, clarifying responsibilities and designating a single point of contact for communication with licensees, and planning and reporting on compliance activities with more consistency.

Clarifying the President's dual role

6.58 We noted in 2000 that the President of the CNSC was both the chair of the appointed Commission and the chief executive officer of operations staff, as required by the *Nuclear Safety and Control Act* enacted in 2000. At that time, we found that the combining of both functions contributed to long delays in implementing change and a lack of understanding between Commission members and CNSC staff on some regulatory issues.

6.59 In our follow-up we noted that to address these problems, in April 2001, the Secretariat was created to enhance the independence of the role of the President and the Commission. The Secretariat provides advice and support to Commission members and the President. This independence was further strengthened in July 2004 when the CNSC created the position of Executive Vice-President, Operations Branch. The Executive Vice-President acts as CEO when the President is not available to discuss an item with a licensee or when, in the President's view, it is inappropriate to do so because the matter for discussion is pending a Commission hearing. As chair of the Commission, the President will not meet with a licensee to discuss a matter to be heard before the Commission for up to 60 days before a hearing in order to avoid any perception of undue influence or lack of transparency.

6.60 The CNSC conducted a benchmarking study of domestic and international tribunals and found no comparable organizations that separate the role of chair of the tribunal from the role of the organization's chief executive officer. The CNSC told us that separating these roles could, in its view, seriously impair the Commission's ability to function and it could find no compelling reason to separate the two roles at this time. A few licensees told us that the President's dual role as chair of the Commission and chief executive officer of CNSC operations still presents a problem in resolving some issues prior to a Commission hearing. CNSC, however, continues to believe that licensees have full access to the President and the Executive Vice-President at all appropriate times.

Conclusion

6.61 Overall, the CNSC has made satisfactory progress in implementing several of the recommendations in our 2000 audit. The progress of a systematic, risk-informed approach to regulating nuclear substances and uranium mining and processing has been satisfactory, but developing the same approach to regulating power reactors has been slower than planned. A formal plan, due by March 2005, is expected to help in assigning levels of regulatory effort on the basis of well-articulated risk management, once it has been implemented.

6.62 The CNSC is making satisfactory progress on a compliance program to be applied consistently across nuclear-power-reactor facilities. Progress on assigning clear accountability for managing regulatory activities at power reactor facilities to the compliance and licensing directors is also satisfactory.

6.63 The CNSC has made satisfactory progress in addressing the need for regulatory documents. It issued key regulatory documents and put in place a process for assigning priorities among new regulatory policies, standards, and guides to be developed.

6.64 The CNSC has developed a new scale for rating the safety performance of power reactor licensees, which has improved its communication with them. It has committed to improving the consistency of its ratings and to communicating their basis more effectively to its staff and its licensees, along with the measures by which licensees can improve their ratings.

6.65 The CNSC has decided not to separate the roles of chair of the Commission and chief executive officer of CNSC operations at this time, and it has clarified its position on this issue.

6.66 Actions taken to address our recommendations on human resources management have been satisfactory.

Canadian Nuclear Safety Commission's response. The Canadian Nuclear Safety Commission remains strongly committed to ongoing improvements in the area of the focus of this audit, power reactor regulation, as well as in all other areas of regulation within the CNSC's mandate. In support of this, we have welcomed the efforts of the Auditor General in assessing the CNSC's performance in power reactor regulation in a systematic manner, in identifying strengths and weaknesses, and in providing advice on how improvements can be made. We believe the findings are fair and are consistent with the CNSC's pursuit of continuous improvement.

About the Follow-Up

Objectives

The objective of this follow-up audit was to assess the progress the CNSC has made since our previous audit in 2000 to improve its regulatory regime for power reactors to ensure that it continues to protect the health and safety of Canadians.

Our previous audit (December 2000 Report, Chapter 27) concluded that the CNSC's regulatory activities were not based on a rigorous, well-documented system of risk analysis, and the ratings it assigned to licensees for safety performance were not clear. We concluded that if the CNSC strengthened its risk analysis, completed the changes it had begun in compliance and enforcement, and took the necessary steps to ensure that it would have the human resource capacity needed in the future, the regulatory regime for power reactors would achieve its safety objective and other objectives.

Scope and approach

Our follow-up audit covered the recommendations in our December 2000 Report. The CNSC management decided that many of our recommendations on power reactor regulation also applied to other areas of its mandate. As a result, management has been implementing changes in the other service lines—Nuclear Substance Regulation and Nuclear Cycle and Facilities Regulation.

While our follow-up audit took into account CNSC's overall progress in implementing a risk-informed regulatory approach in other areas of its mandate, our primary focus was on the licensing and regulation of power reactors.

We interviewed senior managers and key staff responsible for nuclear regulatory activities in each of the five directorates in the Operations Branch and senior officials in the Corporate Services Branch. Included in the interviews were compliance and licensing directors responsible for site offices located at nuclear power stations. We also interviewed licensees, many of whom had been included in the 2000 audit, for their perspective on the CNSC's progress on the audit recommendations. We reviewed extensive documentation relating to the audit issues and numerous reports on other nuclear regulatory agencies. We reviewed key systems and processes used by the CNSC to plan, implement, and report on regulatory activities. During the follow-up, we kept senior management informed on our progress and our preliminary findings.

Most of our audit was conducted in December 2003 and January 2004. However, we also conducted limited audit work in September 2004 to assess more recent progress.

Criteria

We expected that the CNSC would have made satisfactory progress in implementing our recommendations. We assessed its progress using criteria consistent with and drawn from our criteria in the original audit.

CNSC's regulatory programs should be designed, organized, and implemented on the basis of

- a comprehensive analysis of health and safety risks, and sufficient staff, expertise, and resources;
- a comprehensive analysis of other regulatory regimes to address identified risks, including an assessment of the capabilities of industry and government, consultations with stakeholders, costs and benefits, and policies for maintaining transparency and public access to information;
- a clear statement of the respective responsibilities of government, industry, and other parties, and ongoing consultations with stakeholders;
- clear and comprehensive performance objectives or goals for each of the areas subject to regulation;
- clearly defined key performance data, measurement procedures and data to be used, and policies for government to have timely and unimpeded access to all necessary data;

- clear policies and procedures for ensuring compliance with and enforcement of Canadian laws and international standards (to which CNSC has agreed), for resolving complaints, and for reporting and remedying regulatory failures, including any penalties that may be imposed; and
- clear, accurate, comprehensive, and timely reporting to management and Parliament on the relevance of regulations, their effectiveness, and the cost of the programs.

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Chapter

7

Governance of Crown Corporations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Governance of Crown Corporations

Main Points

7.1 Overall, progress in addressing the recommendations from our 2000 audit of Crown corporation governance has been unsatisfactory. Individual Crown corporations have strengthened their own governance structures and practices. However, improvements that we recommended to strengthen the overall governance and accountability framework have not progressed as quickly and as far as we had expected.

7.2 Still, we found fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

7.3 Indications that governance practices have either not improved or improved slowly include the following:

- It took more than three years for the government to address some of our key 2000 recommendations by starting the Treasury Board Secretariat review of corporate governance in February 2004.
- A revised process for appointing Crown corporation boards of directors, chairs, and chief executive officers (CEO) was announced in March 2004 but has not yet been fully defined and implemented.
- Board, chair, and CEO appointments still take too long and terms of board members are not adequately staggered.
- We found very little progress in assessing the capacities and skills needed by the government to review corporate plans and ensure the continued relevance of Crown corporation mandates.
- The responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

Background and other observations

7.4 This chapter assesses the progress that the government and Crown corporations have made in dealing with the concerns we reported in 2000. It also discusses recent developments in corporate governance elsewhere and their possible implications for the governance and accountability framework of Crown corporations.

7.5 Developments in corporate governance are raising the expectations for publicly traded corporations. These developments have yet to be adapted to the governance practices expected of Crown corporations. The emerging private

sector practices that we think are the most relevant to Crown corporations are the following:

- ensuring that the board plays a key role in its own renewal and in the selection of the chair and CEO;
- strengthening the independence of boards and audit committees;
- requiring that the mandate and operations of the board be defined;
- strengthening corporate values and ethics practices; and
- improving the quality of reporting and disclosure.

At the time of writing this chapter, the Treasury Board Secretariat's review of Crown corporations' governance was still underway. The Secretariat informed us that it is considering these issues in its review.

The government has responded. The Treasury Board Secretariat states that the government remains committed to improving the governance of Crown corporations. The Treasury Board Secretariat also states that the current government's review of Crown corporation governance is examining many of the issues identified in the chapter and will address our recommendations.

Reaction from Crown corporation chairs and CEOs indicates that, for the most part, they agree with the recommendations directed specifically at them.

Introduction

7.6 Crown corporations are distinct legal entities that are wholly owned by the government. They deliver important public programs and operate in many sectors of the Canadian economy, including financial services, culture, transportation, agriculture and fisheries, energy and resources, and government services.

7.7 Crown corporations account for a significant portion of government activity. There are currently 43 federal Crown corporations (not including subsidiaries), employing 73,100 people. In aggregate (excluding the Bank of Canada), they manage $78 billion in assets. Parliamentary appropriations to Crown corporations amounted to $5.2 billion in 2003–04.

7.8 While Crown corporations represent a significant opportunity to achieve public policy and other goals and to generate revenue, they also represent significant exposure to potential financial losses and other risks. It is critical that Crown corporations, as public sector entities, be well governed if taxpayers' money is to be well managed.

7.9 Corporate governance refers to the process and structure for overseeing the direction and management of a corporation so that it carries out its mandate and objectives effectively.

7.10 The legislative framework for the governance and accountability of most federal Crown corporations is set out in Part X of the *Financial Administration Act* (FAA). For some "exempt" corporations where Parliament wanted to create further distance from the government, the governance and accountability regime is normally set out in their enabling legislation. In addition to these legislative requirements, governance principles and practices for Crown corporations are contained in various other documents such as governance policies, guidelines, and practices issued by the Treasury Board Secretariat and the Privy Council Office. Individual Crown corporations also establish their own internal policies and practices on governance.

7.11 The governance regimes attempt to balance the Crown corporation's relationship with the government—between the corporation's autonomy in day-to-day activities and the government's appropriate direction and control. The legislation places the board of directors at the centre of the governance regime for Crown corporations. Under this governance regime, the board oversees the management of each corporation and holds management responsible for its performance; it is responsible for establishing the corporation's strategic direction, safeguarding the corporation's resources, monitoring corporate performance, and reporting to the government and Parliament. The corporation is accountable to Parliament through a responsible minister.

7.12 Although the formal ownership structure varies among federal Crown corporations, in substance, the Government of Canada acts as the shareholder for federal Crown corporations and will be referred to as such in

the remainder of this chapter. In practice, several individuals and organizations are involved in the discharge of the government's responsibilities in relation to Crown corporations:

- the Governor in Council
- the responsible minister, deputy minister, and department
- the Treasury Board and its Secretariat
- the Minister and Department of Finance Canada
- the Privy Council Office
- the Prime Minister's Office

7.13 Our audit in 2000 assessed how well three key aspects of corporate governance required by the *Financial Administration Act* were functioning in Crown corporations:

- the process of appointing directors, the board chair, and the chief executive officer (CEO);
- the composition, role, responsibilities, and performance of the board's audit committee; and
- the government's capacity to set and communicate performance expectations, review and challenge the corporation's corporate plan before approving it, and ensure that the Crown corporation's mandate continues to be relevant.

Important developments and initiatives since our 2000 audit

7.14 Following the recent corporate scandals in the United States and Canada, legislators and securities regulators in both countries have focussed on strengthening governance practices in publicly traded corporations. Considerable attention has been given to the need to set clear expectations for the performance of boards, audit committees, and management, and for the disclosure of information to various stakeholders. Legislation in the United States (*Sarbanes-Oxley Act*) and actions of securities regulators in Canada are turning these new expectations for good governance into requirements.

7.15 In February 2004, the President of the Treasury Board announced a series of reviews of government operations and management, including the *Financial Administration Act*, the governance of Crown corporations, and the accountabilities of ministers and senior public servants. Our Office has provided input to these reviews, including our perspective on the governance of Crown corporations and the accountability framework in Part X of the FAA, and our suggestions for improving them. At the end of our follow-up, the Treasury Board Secretariat had not yet completed its reports on these reviews.

7.16 Another significant development is the Commission of Inquiry into the Sponsorship Program and Advertising Activities (the Gomery Commission). The Commission's mandate includes examining the adequacy of the current

accountability framework for Crown corporations. The Commission is still holding hearings and is currently scheduled to report in December 2005.

7.17 In February 2004, the government stated that "a transparent appointment system must be put in place to ensure that citizens have confidence that the best people to serve Canadians are being appointed to public institutions." In March 2004, the government announced important changes to the process for appointing directors, chairs, and CEOs of Crown corporations. At the time of writing the chapter, this revised process was still being implemented.

Focus of the follow-up

7.18 This chapter reports on the extent of the government's and Crown corporations' progress in addressing the recommendations from our 2000 Report and our 2002 audit observation on compensation to executives of Crown corporations.

7.19 In 2001, the House of Commons Standing Committee on Public Accounts held a hearing on our 2000 chapter; its report in early 2002 echoed many of our concerns and made 10 recommendations to the government. In Appendix A, we summarize the status of the government's actions to address each of the Committee's recommendations.

7.20 In this chapter we also discuss recent developments in the governance practices of publicly traded corporations and our views on their relevance to federal Crown corporations.

7.21 Further details on the objectives and scope of our follow-up audit are included in **About the Follow-Up**, at the end of the chapter.

Observations

Appointing directors, board chairs, and chief executive officers

7.22 In a "board-centered" model of governance, the board of directors is responsible for the affairs of the corporation. For good governance, it is essential that the process of selecting and appointing people to the board gives it the right combination of skills and abilities to carry out its mandate and responsibilities effectively.

7.23 Our audit in 2000 found that the government needed to strengthen its appointment process to address the following weaknesses:

- Crown corporations needed to define more clearly the skills and capabilities required on their boards, and the government needed to act on those requirements.
- Although board membership reflected Canada's diversity, it lacked some of the key skills and capabilities needed to oversee the corporation's affairs effectively.
- New directors were given orientation training but were not briefed adequately on their duties and responsibilities, the corporation's

relationship to the government, policies on the compensation of Crown corporation executives, and board procedures.

- Boards of directors were not engaged enough in the renewal of the board and the selection of its chair.
- Appointments to boards were not timely and directors' terms were unevenly staggered, a serious problem that undermined the continuity and stability of boards.

We also advocated a "board search" model for the selection of the chief executive officer, in which the board would play a key role.

Despite some improvements, weaknesses in the appointment process remain

7.24 In our follow-up audit, we reassessed the appointment process in place before the government announced the revised process in March 2004. We found a number of improvements; however, some key concerns we raised in 2000 had not been resolved.

7.25 Following our 2000 audit, the Privy Council Office (PCO) issued a guide to assist Crown corporations in preparing directors' profiles. It subsequently requested all Crown corporations to develop/update their profiles. We noted that most Crown corporation boards now have in place director profiles, most of which reflect the diversity of Canada and the skills and abilities needed to oversee the affairs of the corporation. The expected skills and abilities include, among others, financial and human resources expertise, industry-specific knowledge, and personal and other qualities. Boards use the profiles to identify gaps in the needed mix of skills and communicate in writing to responsible ministers and the PCO. There are now more directors who have the skills and abilities expected by board profiles, especially financial expertise and financial literacy.

7.26 In 2003, the PCO established an orientation course for new directors in response to our 2000 recommendation. The new course covers board procedures, compensation policies, the director's fiduciary responsibilities to the corporation, and the corporation's relationship to the government. The PCO informed us that, so far, 80 percent of Crown corporations have participated in the training program.

7.27 However, some key concerns we noted in 2000 had not been resolved. We noted difficulties in bringing people onto boards with the needed skills, abilities, and experience. It took one corporation two years, and repeated requests, to have the government appoint a member to its board with the proper financial expertise.

7.28 The *Financial Administration Act* requires the responsible minister to consult with the board prior to the appointment of a chair or CEO. However, we found that the government's consultation with boards on the selection of a chair had been uneven.

7.29 Crown corporations were still not making systematic use of a "board search" model to ensure that the board plays a key role in selecting a new CEO. A selection process that does not involve the board weakens the

accountability relationship between the board and the CEO. If CEOs are not appointed or selected by the board, they may believe that they are accountable to the organization or individual that selected and appointed them. As discussed later in the chapter, the revised appointment process announced in March 2004 provides for board involvement in the appointment of chairs and CEOs.

Appointments are not timely, and terms are still not evenly staggered

7.30 The timeliness of appointments of directors, board chairs, and CEOs is still a major issue. In fact, the length of time that board members continue to serve after their terms as directors have expired has increased by 20 percent since we raised this concern in 2000. As shown in Exhibit 7.1, at September 2004, over one third (56) of directors (excluding CEOs, chairs, and directors from the public sector) of the 15 largest Crown corporations

Exhibit 7.1 Timeliness of appointments of directors to Crown corporations' boards

Number of terms expired and average time since expiration (15 largest Crown corporations*)

Fifteen largest Crown corporations	Number of directors (excluding CEOs, chairs, and directors from the public sector)	Number whose terms have expired	Average time since term expired, at September 2004 (days)
Atomic Energy of Canada Limited	15	5	199
Bank of Canada	12	2	397
Business Development Bank of Canada	11	5	420
Canada Deposit Insurance Corporation	5	2	250
Canada Mortgage and Housing Corporation	7	4	239
Canada Pension Plan Investment Board	11	5	340
Canada Post Corporation	9	1	112
Canadian Broadcasting Corporation	9	5	149
Export Development Canada	11	6	439
Farm Credit Canada	10	1	34
Marine Atlantic Inc.	11	0	N/A
National Capital Commission	14	5	322
Public Sector Pension Investment Board	9	4	187
Royal Canadian Mint	8	3	62
Via Rail Canada Inc.	13	8	135
Total	**155**	**56**	

*15 largest Crown corporations by number of employees, assets, and revenues

Source: Privy Council Office

were still sitting on boards while their terms had expired. In 9 corporations, the average length of time that directors had served since their term expired was more than six months.

7.31 At the time of writing this chapter, four major Crown corporations (Via Rail Canada Inc., Business Development Bank of Canada, Export Development Canada, and Canada Post Corporation) had CEOs who had been acting in the position temporarily, in some cases, for more than eight months. These four Crown corporations represent some of the largest corporations in Canada, managing assets totalling $37.3 billion and employing 51,000 people. In our view, these senior positions need to be filled by permanent CEOs on a high-priority basis.

7.32 Appointments to the board are still not staggered evenly, increasing the risk that continuity of expertise and corporate memory will be lost. For example, one Crown corporation was in the process of replacing or renewing the appointments of 8 of its 12 directors during 2004. In addition, we have identified 12 corporations in which the terms of the majority of their directors will expire in the same year. The *Financial Administration Act* sets the terms of directors of Crown corporations to up to three years. In our view, increasing this limit could facilitate the staggering of appointments.

The revised appointment process could improve Crown corporation governance

7.33 In March 2004, the government announced important changes to the process for appointing directors, chairs, and CEOs of Crown corporations. Following the announcement, the process was further refined. In April 2004, the President of the Treasury Board advised individual Crown corporations that their organization was required to follow this process in the future for appointment of the CEO, board of directors, and chairperson, unless the enabling legislation of their organization provided otherwise (see Appendix B).

7.34 At the time of writing this chapter, the government had appointed only a small number of new directors to boards of Crown corporations since the March announcement. In early October 2004, the Privy Council Office informed us that the revised appointment process was still being refined—for example, parliamentary committees were still looking at the positions that would be subject to their review. The Treasury Board Secretariat advised us that its review of Crown corporation governance will also address the appointment process.

7.35 In our view, the revised process has the potential to address many of the issues we raised in 2000. It reflects some of the best practices in Canada and in other jurisdictions. For example, boards of directors, through their nominating committees, would play a significant role in board renewal by screening and recommending suitable candidates for director positions; that should contribute to removing any remaining gaps in skills and abilities. In screening those candidates, the nominating committee will need to pay particular attention to their personal and other qualities, such as being

independent-minded, that could have an impact on board dynamics and the board's effectiveness in challenging management.

7.36 There are only a few Crown corporations where the CEO is appointed by the board of directors. In most cases, CEOs are appointed by the Governor in Council. For the latter corporations, the revised process gives the board of directors a larger role than previously in identifying potential candidates for the CEO positions and recommending them to the minister. This is a significant step in enhancing the involvement of the board, although it differs from practices in the private sector. There, the board of directors is responsible for the selection, appointment, and termination of the CEO. In our view, having the board of directors play the lead role in selecting the CEO will contribute to enhancing his/her accountability to the board.

7.37 However, the problems of timeliness and staggering of appointments may not necessarily be corrected by the revised process. It will be important for the government to ensure that these issues are properly addressed.

7.38 The appointment process for senior executives of Crown corporations provides that some steps do not necessarily have to be followed. In our view, exceptions to the process need to be well supported and their rationale made public.

7.39 Although the revised process has the potential to improve Crown corporation governance, it will not be possible to assess its effectiveness until the process operates for some time.

The functioning of audit committees

7.40 The audit committee is a core committee of the corporation's board of directors and an essential part of good corporate governance. How it performs is an indication of how well the corporation's governance regime is functioning. In 2000, we looked at the performance of 14 Crown corporation audit committees. We compared their practices with about a dozen recognized best practices at the time in Canada and elsewhere to provide a basis for future self-assessment and to identify any potential for improvement in their performance.

7.41 We reported in 2000 that half of the 14 audit committees were ineffective or only marginally effective. As part of this follow-up, we returned to each of those committees to assess their progress against the same best practices we had used as benchmarks in 2000 (Appendix C sets out those practices).

Audit committees have improved their performance

7.42 Our follow-up audit found that Crown corporation audit committees are now following many of the best practices we identified in 2000 and have generally improved their performance.

7.43 Thirteen of the committees have charters or terms of references that reflect the best practices we identified in 2000. For example, the charters acknowledge key audit committee responsibilities such as overseeing the financial reporting process and the audit regime, and reporting to the full board of directors. We also noted a significant improvement in some

committees' oversight of corporate risk management and the internal control environment. Operating procedures of 11 of the 14 audit committees include regular private meetings with the auditors and with management.

7.44 In general, audit committee members are financially literate. They now have stronger financial skills and abilities and consequently have been more effective in reviewing and challenging management's actions and proposals. Overall, we found that nine of the audit committees now fulfill their roles and responsibilities effectively; the five others are still marginally effective.

7.45 Still, there is room for further improvement in how audit committees function in a number of Crown corporations. We noted individual cases where, for example, the audit committee did not effectively challenge management. The quality of information provided to the audit committee could be improved (information could be more timely and complete). In some cases, the committee could better demonstrate how it fulfills its responsibility for overseeing the ethical practices of the corporation; this could be done through an annual review of management's compliance with the corporate code of conduct. Finally, some audit committees were still not playing an active role in soliciting information about significant risks and exposures and reviewing the adequacy of internal controls to manage those risks.

7.46 In October 2003, the Treasury Board Secretariat issued *Guidelines for Audit Committees*. These guidelines suggest best practices for audit committees of federal Crown corporations. They present practices to help individual audit committees improve their effectiveness. Boards of directors and audit committees are to tailor the guidelines to meet their specific needs. As mentioned later in this chapter, with expectations for audit committees continuing to increase, the guidelines need to be updated to show clearly what the government expects of effective audit committees.

Clarifying relationships and expectations with the shareholder

7.47 Establishing and following good governance practices provide assurance to the shareholder and stakeholders that the corporation is being managed in an appropriate way to achieve the expected results. Ensuring that the roles and responsibilities of all key parties in governance are clear, that performance expectations are set and understood, and that all parties are accountable for their performance contributes to the achievement of corporate objectives.

7.48 We reported in 2000 that the government had limited knowledge and expertise to challenge the corporate plans of Crown corporations. Our special examinations had identified weaknesses in the strategic planning of 66 percent of Crown corporations. Thus, the government was approving many deficient corporate plans.

7.49 We also noted that only two Crown corporations had been subject to mandatory and systematic mandate reviews. Other corporations carried out mandate reviews on a generally ad hoc basis, and many reviews did not engage the Treasury Board, the responsible minister, and Parliament or address all significant issues. Thus, we recommended that the government develop guidelines for conducting mandate reviews.

7.50 In 2000, we also found that the roles and responsibilities of key players in Crown corporation governance needed to be clarified. Further, we noted that no process of formal communication was in place between each Crown corporation and the responsible minister to provide for needed dialogue and consensus. In addition, we found that half of corporations that we examined rarely saw their minister.

7.51 We concluded that these weaknesses impeded the successful implementation of Part X of the *Financial Administration Act* (FAA) and affected the quality of Crown corporation governance. In our follow-up audit, we found little progress in addressing these issues.

Weaknesses remain in the review of corporate plans and mandate relevance

7.52 Feedback from the government on corporate plans is still limited. Neither the Treasury Board Secretariat nor the applicable departments have clearly defined their respective roles in the process for reviewing and approving corporate plans or assessed the capacity and skills needed to fulfill their roles.

7.53 Recent special examinations of Crown corporations continue to reveal weaknesses in corporate planning. Many Crown corporations still are not setting clear goals and indicators of performance for their public policy objectives. Some deficient corporate plans are still being approved.

7.54 Crown corporations that undergo mandate reviews are still the exception, and the reviews are still usually carried out on an ad hoc basis. There are still no guidelines for conducting mandate reviews. In Chapter 8 of our November 2004 Report to Parliament, we commented on Telefilm Canada; its corporate activities had changed but its mandate had not been amended to authorize the changes (Exhibit 7.2). Periodic and systematic

Exhibit 7.2 Telefilm Canada—Most of its activities are not consistent with its constituting legislation

The mission of Telefilm Canada, as stated in the *Telefilm Canada Act*, is to foster and promote the development of the feature film industry in Canada. Since the adoption of the Act in 1967, the activities of the Corporation have extended to the television, new media, and music sectors through memoranda of understanding and/or contribution agreements with the Department of Canadian Heritage. The majority of the Corporation's expenses are related to these new sectors of activity.

This expansion of Telefilm Canada's role and responsibilities in the development of the audiovisual and cultural industries has not been matched by an updating of its legislative mandate and powers—which today, 37 years after Telefilm Canada's creation, are still limited to developing the feature film industry. Parliament has not ratified the government's decision to extend Telefilm Canada's mandate to other sectors of activity. In our opinion, if the government intends to have Telefilm Canada support the development of the television, new media, and music industries, it is important that it bring forward the changes needed to modernize the Act. At the time of writing this chapter, the government had just tabled Bill C-18 in the House of Commons to update Telefilm's mandate. The Bill was referred to the Standing Committee on Canadian Heritage for review.

mandate reviews would help Parliament and the board ensure that the corporation's mandate is relevant to the government's policy objectives and the corporation's operating environment.

Relationships and accountability still need to be clarified

7.55 As mentioned previously, the *Financial Administration Act* places the board of directors at the centre of the governance regime for Crown corporations. The government retains power and influence over Crown corporations in areas such as appointment and remuneration of directors, chairs, and chief executive officers; directives and regulations; and approval of corporate plans and budgets. While the government's authority for Crown corporations rests with the responsible minister, in practice several players are involved in these areas.

7.56 Over the years, we have found that various representatives of the government do not always speak with one voice. While Part X of the FAA indicates that Crown corporations are accountable to Parliament through the responsible minister, it is not always clear what ministerial responsibility for a Crown corporation means in practice. The Gomery Commission and the Treasury Board Secretariat's reviews have mandates to explore this issue. Clarifying the corporation's relationship to the government and who speaks for the shareholder are essential for good corporate governance of all Crown corporations, including those exempt from Part X of the FAA.

7.57 Our 2000 chapter raised concerns about the role played by senior public servants appointed to the boards of some Crown corporations. In our view, representatives of the government, such as deputy ministers, can too easily be viewed as having a "super voice" and thereby unduly affect the direction of the board. Boards require access to public sector decision makers but not necessarily as members of the board.

7.58 In recent special examinations, we noted a lack of clarity among board members about the role of directors from the public sector. At times, board members deferred to them because they were considered to speak for the government. While directors from the public sector may have the knowledge and expertise to help other board members appreciate the government's position on certain issues, their function is not to convey direction from the minister to the board. They have the same statutory obligations as any other director: to exercise independent judgment in ways that best fulfill their responsibility to the corporation. Having the fiduciary responsibility to act in the best interest of the corporation and owing loyalty to their minister can place them in difficult situations at times. In our view, it is important to reassess the merits of having public sector directors on boards.

Communicating expectations—governance protocols between ministers and Crown corporations

7.59 There is still no formal process for setting out high-level expectations of the responsible minister before the corporate plan is developed. In practice, the relationship between boards of directors and responsible ministers varies—some meet regularly; others do not. A process to ensure that

expectations are clear could help the board and the minister establish a mutual understanding of the corporation's mandate, the related performance expectations, public policy issues, and the shareholder's strategic priorities. This would be useful to the board in establishing the corporation's strategic direction and developing the corporate plan.

7.60 In other jurisdictions, there have been some efforts to clarify and publicly disclose shareholders' policy objectives and expectations. For example, the government of British Columbia now has a governance structure designed to clarify the relationship between the Province and provincial Crown corporations (Exhibit 7.3). We understand that communication between the responsible ministers and the corporations has improved. Such a governance structure should help to clarify the relationship between the corporation and the responsible minister and should ensure that the government speaks transparently and with "one voice."

Exhibit 7.3 A process used to clarify expectations between the government and a Crown corporation

In the British Columbia model, the minister responsible for the Crown corporation, as the representative of the government, communicates broad strategic direction and expectations as determined by the Cabinet. This direction and formal expectations for the Corporation are communicated annually in a "letter of expectations" that is also signed by the Crown corporation board's chair and made public. This letter also identifies actions the government will take to assist the Crown corporation in achieving mandate and operational objectives. The minister responsible for the corporation is the voice of the government. By playing a role in establishing the corporation's direction and the government's expectations of it, the minister is reflecting the expectations of the owner and there is a basis for accountability for the corporation's actions. In this model, the minister does not take over the role of the board but communicates formally and publicly the performance that the government expects from the corporation. The board is responsible for governing the corporation within that framework.

Source: Office of the Premier, Province of British Columbia

7.61 A clear role for the minister in establishing and communicating formal, high-level expectations of the corporation would also help ensure the continued relevance of a Crown corporation's mandate. Special considerations may need to be taken into account for Crown corporations that are presently exempt from Part X of the *Financial Administration Act*.

Disclosure of executive compensation

7.62 In December 2002, we reported the need for improved transparency of senior executives' salaries and other compensation. In the two years since our audit observation, very little has happened. Only a few federal Crown corporations disclose some information on executive compensation. Corporations listed on stock exchanges are required to disclose the total compensation (including remuneration and benefits) of senior executives and board members. These practices reinforce that a best practice is for boards and executives to disclose such information.

Implications of Recent Developments in Corporate Governance

New Canadian expectations

7.63 As mentioned earlier in the chapter, the recent corporate scandals in the United States and Canada have led legislators and securities regulators in both countries to strengthen their requirements for the governance practices of publicly traded corporations. In the United States, these requirements were set out in the *Sarbanes-Oxley Act* of 2002. In Canada, securities regulators have proposed expected best practices in National Policy 58-201, which are similar to those in the United States. These proposals now set clear expectations for the performance of boards of directors, audit committees, and management, and for the disclosure of information to various stakeholders.

7.64 Although Crown corporations are not subject to these proposed requirements, we believe that many of the principles underlying them are relevant to the public sector environment and key aspects of them would strengthen the governance practices of Crown corporations and their accountability to Parliament. As part of our ongoing audit work in Crown corporations, we noted the significant efforts of some in the last two years to review and improve their own internal governance policies and practices. Some have already addressed these proposals or are in the process of doing so.

Strengthening the board

7.65 **Composition of the board.** Securities regulators in Canada now recommend that the majority of board members be independent, that the independent members hold regular meetings without management in attendance, and that the board chair be an independent director (that is, the chair and CEO positions should be separate).

7.66 These best practices are not always adopted in Crown corporations. We noted that the practice of holding board meetings without management in attendance is uneven. Further, in a few Crown corporations, the same individual acts as chair and CEO. Finally, as mentioned in paragraphs 7.57 and 7.58, the presence of directors from the public sector on a board of a Crown corporation needs to be reassessed.

7.67 **Board mandate.** Securities regulators propose that a board adopt a formal mandate in which it assumes its stewardship responsibility, including its responsibility to

- satisfy itself of the integrity of the CEO and other senior officers and their promotion of a culture of integrity;
- adopt a strategic planning process and approve at least annually a strategic plan that takes into account opportunities and risks of the corporation;
- identify principal risks of the business and ensure that appropriate systems are put in place to manage those risks;
- plan for succession;

- ensure the integrity of internal control and management information systems; and
- develop an approach to corporate governance that includes governance principles and guidelines specific to the corporation.

7.68 Board mandates will need to set out decisions that require prior approval by the board, measures for receiving feedback from security holders (in the case of a Crown corporation, the shareholder), and the board's expectations of management.

7.69 In our view, all these responsibilities are consistent with expectations for Crown corporations, including those established in the *Financial Administration Act*. Section 131 (2) of the FAA requires boards of Crown corporations to have reasonable assurance that the systems and practices of the corporation safeguard and control the corporation's assets; that the financial, human, and physical resources of the corporation are managed economically and efficiently; and that the operations of the corporation are carried out effectively. As Crown corporations update their board mandates, they should ensure that these requirements, as well as those established in the FAA, are taken into account.

7.70 **Orientation and continuing education.** Regulators propose that all new directors receive a comprehensive orientation and that the board provides opportunities for continuing education to all board members. We have already noted that the federal government recently developed an orientation course for directors of Crown corporations. However, much remains to be done by the government and the Crown corporations in providing continuing education. It is important to put the mechanisms in place to ensure that directors have access to continuing education programs in areas such as public sector developments, governance practices, financial literacy, and risks management.

7.71 **Code of business conduct and ethics.** Boards in publicly traded companies will be required to adopt a written code of business conduct and ethics that is applicable to directors, officers, and employees. The code is to address such issues as conflict of interest; protection and proper use of corporate assets and opportunities; fair dealing with customers, suppliers, competitors, and employees; confidentiality of corporate information; compliance with laws, rules, and regulations; and reporting of any illegal or unethical behaviour. The board will be responsible for monitoring compliance with the code and ensuring that the corporation's ethical standards and values are observed and that the corporation discloses how fully they are observed.

7.72 In our view, the need for boards to establish and monitor values and ethics codes is equally important in Crown corporations as in publicly traded companies. In addition to business ethics, Crown corporations need to reflect values such as serving the public interest. Although our follow-up work did not cover this issue, we noted in our other audit work that many Crown corporations are now reviewing their values and ethics programs and infrastructure. A number of others have already implemented some of the best practices in that area.

7.73 As Crown corporations review their values and ethics programs, they need to reflect both private sector expectations and the principles underpinning the new *Values and Ethics Code for the Public Service*. The government has asked all public service institutions not covered by the Code, including Crown corporations, to respect the Code's spirit and adopt similar provisions for their organizations. A related document is the *Conflict of Interest and Post-Employment Code for Public Office Holders*. This Code applies to order-in-council appointees such as directors, chairs, and CEOs of Crown corporations. Exhibit 7.4 summarizes the key principles of this conflict of interest code.

7.74 In our view, the development and implementation of codes of conduct and ethics are essential elements of good governance. We intend to examine this area in the future, given that many Crown corporations are currently reviewing their ethics and values programs and infrastructure.

7.75 **Regular board assessments.** Boards and board committees of publicly traded companies will be expected to assess their collective effectiveness as well as the effectiveness and contribution of each board member. The assessment is to consider the board's written mandate, the charter of each board committee, and the competencies and skills each director is expected to bring to the board. As noted in our 2000 Report, we support board assessments as a best practice that should be implemented in Crown corporations. Such assessments could help boards identify opportunities to improve their practices or identify skills and abilities that need to be added to the board or its committees.

7.76 In our recent special examinations of Crown corporations, we noted that a number of boards are assessing the board's collective effectiveness and its committees. However, we also noted the need for more effort in assessing the contributions of individual board members. This is important if boards are to improve their effectiveness and fulfill their responsibility for renewal.

7.77 **Director compensation.** In the private sector, the roles and responsibilities of boards of directors—and, more specifically, audit committees—have increased significantly in the last few years. This has resulted in a greater demand for highly qualified people. A recent study reported that, in 2001, compensation to directors in the private sector averaged about $19,000 in annual retainer fees and $1,300 for attending each board meeting. Current literature shows that these fees are significantly higher today, reflecting the increased responsibility and accountability of board directors.

7.78 In Crown corporations, the recommended annual retainer fee ranges from $2,600 to $10,300, and fees for attending board meetings are between $160 and $800. These compensation levels have not changed in the last four years. Chairs and CEOs of Crown corporations have said that compensation has not kept up with the increase in workload and responsibilities. In our view, as the government decides to increase responsibilities of boards of directors, it may want to review the compensation paid to directors in order to confirm its appropriateness in attracting and keeping those who are best qualified.

Exhibit 7.4 Values and ethics for public office holders—key principles

Ethical standards	Public office holders shall act with honesty and uphold the highest ethical standards so that public confidence and trust in the integrity, objectivity, and impartiality of government are conserved and enhanced.
Public scrutiny	Public office holders have an obligation to perform their official duties and arrange their private affairs in a manner that will bear the closest public scrutiny, an obligation that is not fully discharged by simply acting within the law.
Decision making	Public office holders, in fulfilling their official duties and responsibilities, shall make decisions in the public interest and with regard to the merits of each case.
Private interests	Public office holders shall not have private interests, other than those permitted pursuant to this code, that would be affected particularly or significantly by government actions in which they participate.
Public interest	On appointment to office, and thereafter, public office holders shall arrange their private affairs in a manner that will prevent real, potential, or apparent conflicts of interest from arising, but if such a conflict does arise between the private interests of a public office holder and the official duties and responsibilities of that public office holder, the conflict shall be resolved in favour of the public interest.
Gifts and benefits	Public office holders shall not solicit or accept transfers of economic benefit, other than incidental gifts, customary hospitality, or other benefits of nominal value, unless the transfer is pursuant to an enforceable contract or property right of the public office holder.
Preferential treatment	Public office holders shall not step out of their official roles to assist private entities or persons where this would result in preferential treatment to any person.
Insider information	Public office holders shall not knowingly take advantage of, or benefit from, information that is obtained in the course of their official duties and responsibilities and that is not generally available to the public.
Government property	Public office holders shall not directly or indirectly use, or allow the use of, government property of any kind, including property leased to the government, for anything other than officially approved activities.
Post-employment	Public office holders shall not act, after they leave public office, in such a manner as to take improper advantage of their previous office.
Fundraising	Public office holders are not to personally solicit funds from any person, group, organization, or corporation where such fundraising could place public office holders in a position of obligation incompatible with their public duties.

Source: Privy Council Office

Strengthening the audit committee

7.79 As the audit committee is the board committee responsible for oversight of financial controls and disclosure, regulators' and stakeholders' expectations of the audit committee have increased in the last few years, and so has the committee's role.

7.80 Canadian securities regulators recently issued, in multilateral instrument 52-110, requirements for practices that audit committees of publicly traded companies are to follow. These requirements are generally consistent with the best practices we identified for Crown corporations in 2000. However, in a few areas, they go beyond what is expected from audit committees of Crown corporations.

7.81 **Independence.** All members of audit committees are now expected to be independent. This goes well beyond the governance regime of Crown corporations: the *Financial Administration Act* currently requires only that the majority of audit committee members not be members of management or employees of the corporation. Regulators have defined independence for audit committees generally to mean no direct or indirect material relationship with the company. Those prohibited from sitting on the audit committee are current or recent employees or executives of the company, family members of current or recent executives, and partners or employees of the external or internal auditor (or auditors who recently filled the positions). There are also restrictions on compensation for services other than acting as a member of the board.

7.82 Most Crown corporation audit committees have a membership that reflects these expectations. In our view, however, the full independence of audit committees needs to be clearly required in policy or in legislation.

7.83 **Approval of financial disclosure.** Regulators require audit committees to review financial statements, and the management discussions and analysis associated with the statements, before their release. Audit committees must also ensure that adequate procedures are in place for the review of any other financial information to be released by the corporation. Further, audit committees are expected to establish procedures for dealing with complaints or concerns, including those made anonymously, about accounting, internal accounting controls, and audit matters.

7.84 We noted that the audit committees of Crown corporations review, discuss, and approve annual financial statements. However, the review of other key information being disclosed in the annual report or in other public documents is uneven and usually less rigorous. As the demand for better reporting and disclosure increases, these requirements will become increasingly important for audit committees.

7.85 **Handling complaints and concerns.** Finally, the introduction of "whistle-blowing" mechanisms in Crown corporations is still at an early stage. Currently, some audit committees have implemented, or are considering implementing, procedures to handle complaints or concerns from interested parties. The government has introduced legislation in the House of

Commons pertaining to "whistle blowing" in the public service, which will also apply to Crown corporations.

Strengthening expectations of management

7.86 While recent developments in corporate governance have focussed on the board, more is expected of management in a number of areas. In particular, legislators and regulators in the United States and Canada have been requiring management of publicly traded corporations to take personal responsibility for financial disclosure and for the internal controls of the organization. This responsibility is in the form of a public certificate that must be supported by evidence that controls are properly designed and working effectively. Regulators in Canada are currently considering if there is a need for the certificate to be supported by the attestation of the external auditor.

7.87 However, the Crown corporation environment has not experienced the same financial reporting issues that led regulators to require public certification in publicly traded companies. Therefore, we are not presently suggesting that a similar requirement be applied to Crown corporations. Current literature on this subject shows that the cost of implementing a certification process is significant. It is important that any consideration by the government to introduce a similar requirement for Crown corporations include an assessment of the costs and potential benefits of such a measure. Any certification requirement also needs to be tailored to the public sector environment.

Disclosure and reporting—closing the accountability cycle

7.88 We did not examine disclosure and reporting in our 2000 audit of governance in Crown corporations. However, in previous audits and studies we have noted repeatedly that Crown corporations need to improve the quality, timeliness, and completeness of the accountability information in their annual reports.

7.89 In the private sector, expectations for transparency and disclosure of financial and non-financial information have risen significantly for publicly traded companies. In the public sector, there have also been a number of initiatives to enhance public disclosure. Many of these developments could be adapted for federal Crown corporations to improve their disclosure practices.

7.90 Disclosure requirements of publicly traded companies have generally been more rigorous than those required of private companies or public sector corporations. Securities regulators in Canada and the United States have emphasized that managers of publicly traded companies must take more personal responsibility for the financial and non-financial information that they produce and disseminate.

7.91 **Management discussion and analysis of performance.** As part of the regulatory disclosure requirements, all companies are to include in their annual reports a management discussion and analysis (MD&A) of the company's financial condition, the results of its operations, and its cash flows. The analysis must include a comparison with the company's performance of

the previous year. Regulators also require publicly traded companies to disclose their business risks and their key environmental and social policies.

7.92 The purpose of the MD&A is to give users of the financial statements the underlying information on, and reasons for, the reported performance and allow them to understand future trends. Recent guidance by the Canadian Performance Reporting Board of the Canadian Institute of Chartered Accountants (CICA) on MD&A describes accepted practice for these types of disclosure. While its guidance was written primarily for companies that are subject to oversight by securities regulators, the CICA indicated that public sector and non-profit organizations could also use it.

7.93 **Reporting on performance against public policy objectives.** Crown corporations have public policy objectives in addition to any commercial objectives. In our review of Crown corporations' annual reports for the Auditor General's Award for Excellence in Annual Reporting, we have found consistently that many Crown corporations fail to state their public policy objectives and evaluate their performance against them. For example, in 2003 we found that more than half of the Crown corporations did not report how they had performed in meeting their public policy objectives. With the recent guidance from the CICA on MD&A, we expect that analysis of the factors contributing to the achievement of commercial and public policy objectives will improve.

7.94 **Expanding access to information.** Presently, 28 Crown corporations are subject to the *Access to information Act*. The government's Access to Information Review Task Force in 2002 made a number of recommendations that could affect Crown corporations. In particular, the Task Force recommended that criteria be established to determine which institutions should be covered by the *Access to Information Act*. One set of suggested criteria would have the Act apply to any institution that has a majority of board members appointed by the government, receives all its financing through appropriations, or has its controlling interest owned by the government. Another suggested criterion would include institutions that perform functions in an area of federal jurisdiction related to health and safety, the environment, or economic security. The Task Force recommended that exceptions to these criteria be allowed where access to information would be incompatible with the institution's structure or mandate. We understand that the Treasury Board Secretariat's review of Crown corporation governance will address this issue.

7.95 **Making special examination reports public.** With some exceptions, Crown corporations are required to have a special examination conducted at least once every five years. In March 2004, the government announced its intention to have the reports on these examinations made public and tabled in Parliament. However, there is currently no formal requirement to do so. We have issued eight special examination reports since the government announcement in March. At the time of writing this chapter, four Crown corporations had posted their examination reports on their Web sites. In our view, the tabling of special examination reports in Parliament would assist

parliamentarians in their oversight role for Crown corporation activities and performance. The Treasury Board Secretariat's review of Crown corporation governance is also addressing this matter.

7.96 Corporations in both the private and public sectors are being required to improve the quality and increase the quantity of public disclosure. Improved reporting in annual reports and other forms of public disclosure are expected by regulators and required from other public sector entities. These will help to ensure the transparency of operations and help stakeholders hold boards and management to account.

Conclusion and Recommendations

7.97 Overall, progress in addressing the recommendations from our 2000 audit of Crown corporation governance has been unsatisfactory. Individual Crown corporations have strengthened their own governance structures and practices. However, improvements that we recommended to strengthen the overall governance and accountability framework have not progressed as quickly and as far as we had expected.

7.98 Still, we found fewer gaps in the collective skills and expertise of board members. We also found that the composition and operating practices of board audit committees had improved and that audit committees are operating more effectively than in 2000.

7.99 Indications that governance practices have either not improved or improved slowly include the following:

- Only in 2004 did the government start addressing some of our key 2000 recommendations.
- A revised process for appointing Crown corporation boards of directors, chairs, and chief executive officers (CEO) was announced in March 2004 but has not yet been fully defined and implemented.
- It takes too long to appoint board members, chairs, and CEOs. Many board members' terms have expired. Some large Crown corporations are without permanent CEOs.
- The terms of board members are not evenly staggered, increasing the risk that corporate memory will be lost.
- The government has still not assessed the skills and abilities that it needs to review corporate plans and ensure the continued relevance of Crown corporation mandates.
- The responsibilities and expectations of the government regarding Crown corporations still need to be clarified.

7.100 Our recommendations from 2000 to improve the governance of Crown corporations continue to be relevant and valid today, and our review of practices outside the government shows that expectations continue to increase.

7.101 **Recommendation.** As the government establishes new expectations for good governance practices for Crown corporations, it should

- clarify the relationship between the board and the responsible minister and other representatives of the government;
- ensure that the government's expectations of the corporation are formally, clearly, and publicly communicated;
- effectively implement the revised appointment process for directors, chairs, and chief executive officers, paying particular attention to the timeliness and proper staggering of appointments;
- update current governance structures and practices to reflect best practices for the composition, roles, and responsibilities of boards and audit committees, including
  - reassessing the appropriateness of having public sector directors on boards,
  - reassessing independence requirements for members of audit committees, and
  - assessing the costs/benefits of implementing a certification process for internal control; and
- update current expectations for disclosure, reporting, and transparency to reflect best practices in private and public sectors.

7.102 **Recommendation.** In updating their board mandates and governance structures and practices to reflect best practices, boards of directors should

- ensure that directors have access to continuing education;
- develop/review their values and ethics programs and infrastructure to reflect the principles underpinning the new *Values and Ethics Code for the Public Service*;
- ensure that they assess their collective effectiveness as well as the contribution of each member;
- ensure that audit committees review and recommend to the board information that will be disclosed in annual reports and other public documents; and
- ensure that mechanisms are put in place to deal with complaints and concerns from interested parties.

Government's response. The government remains committed to improving the governance of Crown corporations. Many of the issues identified in this report are being examined in the context of the government's review of Crown corporation governance. We believe that the review will respond to the measures recommended in your report.

Crown corporations' responses. It is not practical to obtain the responses of 43 Crown corporations to the recommendations that apply to them directly. However, we did discuss our findings and recommendations with the chairs and/or CEOs of seven Crown corporations. Generally, they supported the main messages of the chapter and agreed with the recommendations directed specifically at Crown corporations.

About the Follow-Up

Objectives

The objectives of this follow-up were to assess the extent of the action taken by the government and Crown corporations to address our recommendations in our December 2000 Report, Chapter 18, Governance of Crown Corporations, and the December 2002 audit observation on executive compensation. We also wanted to determine the potential implications of recent developments in corporate governance on the governance and accountability framework of Crown corporations.

Scope and approach

Our follow-up work focussed on the main issues raised in our December 2000 Report and the related 2002 report of the House of Commons Standing Committee on Public Accounts and in our December 2002 audit observations.

We reviewed current developments in corporate governance in Canada and elsewhere. Based on our Office's past and current work on Crown corporations, we assessed whether changes were needed to strengthen the legislative framework for Crown corporation governance and accountability, and reflect current best practices in Canada and elsewhere.

We reviewed the process for appointing board members and the effectiveness of audit committees in 14 Crown corporations. We also interviewed staff at the Privy Council Office, Treasury Board Secretariat, and in federal departments. We interviewed chief executive officers (CEO), board and audit committee chairs, and corporate secretaries; reviewed files and management reports; and analyzed data. Finally, given that the Auditor General is the statutory auditor of most Crown corporations, we used a combination of document review and our own observations to assess the effectiveness of audit committees.

Criteria

We expected that the Government of Canada would have made satisfactory progress in addressing our recommendations. We used the audit criteria we had used in 2000, which are still relevant. That is, we expected that to protect the shareholder's interest, to ensure that Crown corporations achieve their public policy objectives effectively and efficiently, and to optimize their commercial objectives,

- there should be timely appointments of qualified board chairs, CEOs, and board directors that meet the requirements of the government and the corporation and that strengthen the accountability relationships among the board, the CEO, and the government;
- audit committees should be constituted with appropriate skills and experience, carry out necessary roles and responsibilities, and perform their duties effectively, as measured against best practices;
- the government should conduct a robust review and challenge of a corporation's corporate plan as the basis for the plan's approval; and
- there should be assurance that the mandate of each corporation, including its public policy and financial objectives, continues to be relevant.

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Appendix A Status of the government's action to address recommendations made by the Public Accounts Committee in its Report on Chapter 18 of the December 2000 Report of the Auditor General of Canada

Recommendation	Status
That Treasury Board Secretariat (TBS) assess departmental capacity to review and challenge corporate plans of their respective Crown corporations. Once the assessment is completed, that a report be prepared identifying the areas where departmental review capacity needs strengthening, describing the initiatives required to upgrade departmental systems and practices, together with a timetable for implementation.	Assessment not completed by TBS and no report produced (see paragraph 7.52).
That Treasury Board Secretariat, when receiving the corporate plan for review and recommendation, request from the Crown corporation a copy of the most recent special examination report.	Special examination report to be available on Crown corporation Web site (see paragraph 7.95).
That Treasury Board Secretariat and the Department of Finance execute an assessment of their own capacity to review and challenge corporate plans. Once the assessment is completed, that a report be prepared identifying the areas where review capacity needs strengthening, describing the initiatives required to upgrade systems and practices, together with a timetable for implementation.	Assessment not completed by TBS and Department of Finance; no report produced (see paragraph 7.52).
That each Crown corporation review and amend its selection criteria and procedures for establishing the membership of its audit committee in order to ensure that all its members are financially literate and further ensure that at least one member possesses the required knowledge and experience in financial management and accounting.	Implemented (see paragraphs 7.43 and 7.44).
That the Privy Council Office provide assistance to Crown corporations in developing board skills profiles and ensure that these profiles are submitted in timely fashion to the responsible minister and the Prime Minister's Office.	Implemented (see paragraph 7.25).
That the government and the responsible ministers of Crown corporations take into consideration the skills profiles of candidates when selecting and appointing board chairs and directors.	Some progress, at March 2004 (see paragraphs 7.17, 7.25, and 7.27). Revised appointment process being implemented (see paragraphs 7.33 to 7.38).
That the government consider developing a formal mechanism or process that would permit a systematic review of a Crown corporation's mandate, executed on a ten-year basis or when significant changes to government policy or to the economic environment occur that impact on the relevance of the Crown corporation's mandate.	Not implemented (see paragraph 7.54).
That the government review and amend the process of appointing directors and chief executive officers (CEOs) to Crown corporations in order to ensure greater involvement of the Crown corporation's board of directors in recommending potential candidates to the Governor in Council.	Revised process being implemented (see paragraphs 7.33 to 7.38).
That the government prepare a transitional strategy that would allow certain Crown corporation boards the opportunity to build up the required capacity to conduct effective candidate searches for recommendation to the Governor in Council.	Revised process being implemented (see paragraphs 7.33 to 7.38).
That the government evaluate the practicality of applying best practices found in other countries or jurisdictions for appointing senior officers to public sector or government-owned corporations. That the government prepare a report containing recommendations based on the best practices.	Completed; report prepared by the Privy Council Office. Revised process being implemented (see paragraphs 7.33 to 7.38).

Appendix B Appointment process for senior executives of Crown corporations

Nominating committee

The board of directors must establish a nominating committee to identify candidates for the positions of CEO, chairperson, and directors. This committee may include outside eminent persons. In undertaking its work, the nominating committee will need to rely on rigorous processes involving the use of a professional recruitment firm, where appropriate, as well as public advertisements for the selection of the CEO and chairperson. In particular, it will have to develop selection criteria for the CEO and chairperson, as well as a competency profile for the board as a whole. In the case of the CEO and chairperson, the positions would normally be advertised in the *Canada Gazette* and national newspapers. For all positions, including those of directors, the nominating committee will normally seek the assistance of an executive search firm.

Selection criteria for CEO and chairperson

The selection criteria for the CEO and chairperson should consist of the following elements: education, experience, knowledge, abilities, and personal suitability required for the position. Abilities could include characteristics such as corporate vision, leadership, and the ability to communicate effectively with stakeholders. Personal suitability could include attributes such as ethical character and sound judgment.

Board competency profile

For directors, a board competency profile should be developed. This is a description of the experience, attributes, and skills that should be possessed by the board as a whole. This profile will be based on the roles and responsibilities of the board, and may include a set of generic attributes that all board members must have, such as adaptability, sound judgment, collegiality, and financial acumen, as well as specific attributes such as knowledge of the industry. The profile should also recognize the need for the board to be representative of the Canadian population and of Canada's geographic regions. Additional information on how to build a director's competency profile can be found on the Privy Council Office Web site.

Director's skills profile

In filling a director's position, the nominating committee will want to assess the skills of those already on the board. Having done this, and taking into consideration the board profile, the committee can identify the specific competencies required to complete the skills mix for the board as a whole.

Agreement on selection criteria and board profile

Once selection criteria and board competency profiles have been completed, these will need to be discussed with the responsible minister's office, the director of appointments in the Prime Minister's Office, and the Senior Personnel and Special Projects Secretariat of the Privy Council Office.

Responsible minister's review of candidate list

Once a list of suitable candidates for the positions of CEO, chairperson, and director has been developed by the nominating committee using the approach above, it will be submitted to the board of directors, who will provide a short list of candidates to the minister responsible for the corporation. Based on this list, the minister will make a recommendation for appointment. The appropriate parliamentary committee may then review the candidate recommended by the minister.

Re-appointments

In the case of re-appointments, the nominating committee will want to assure itself that the individual has the competencies required for the position. This being the case, the name of this individual will be submitted to the responsible minister who will make a recommendation for re-appointment. The appropriate parliamentary committee may then review the candidate recommended by the minister.

Additional information

Additional information on these processes can be obtained from the Senior Personnel and Special Projects Secretariat of the Privy Council Office, which will also be responsible for the placement of advertisements in the *Canada Gazette*.

Source: The Treasury Board of Canada

Appendix C Selected best practices for audit committees

Best practices since 2000 are highlighted in blue

The audit committee should ensure financial oversight by

- critically reviewing the interim and annual financial statements, the auditor's report, and the management discussion and analysis section of the annual report;
- ensuring that presentation of financial statements is fair, appropriate, and clear, and that it meets generally accepted accounting principles; and
- actively soliciting the external auditor's judgments about the acceptability and the quality of the corporation's accounting principles as applied in its financial reporting. This discussion should include such issues as the clarity of financial disclosure and the aggressiveness or conservatism of the corporation's accounting principles and estimates.

The audit committee should ensure oversight of corporate books, records, financial and management control and information systems, and management practices by

- reviewing the special examination plan and report prepared by the external examiner;
- actively soliciting information about significant risks and exposures and reviewing the adequacy of internal controls to manage those risks;
- reviewing the integrity and effectiveness of the management information systems;
- reviewing internal audit plans and reports and management's subsequent actions; and
- reviewing significant findings and recommendations made by the external auditor and examiner and following up on management's subsequent actions.

The audit committee should

- ensure ethical oversight through the annual review of management's compliance with the corporate code of conduct;
- actively solicit all sensitive information (for example, senior management expenses, significant litigation, non-compliance with laws and regulations, misuse of corporate assets, illegal activities);
- oversee the resolution and investigation of complaints of wrongdoing (audit committee mandates should include the requirement for a process to investigate and resolve all complaints, including those made anonymously);
- ensure that internal audit is adequately resourced and that it has adequately covered the major risks and activities of the corporation; and
- recommend external auditors and their compensation, and pre-approve all non-audit services by external auditors to ensure that their objectivity and independence are preserved.

Membership and competencies

- Audit committees should be composed of at least three members. Each member should be an independent director, who should not be an officer or an employee of the corporation.
- Although a variety of skills and experience is beneficial to an effective and balanced audit committee, all members should be financially literate and at least one member should have accounting or related financial management expertise. Financial "literacy" signifies the ability to read and understand fundamental financial statements, including a balance sheet, income statement and cash flow statement, and the ability to ask probing questions about the corporation's financial risks and accounting. "Expertise" signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication (experience as a chief executive officer, for example, or other senior officer with financial oversight responsibilities).

Operating procedures

Terms of reference. Audit committees should have clear, written terms of reference and operating procedures that specify the scope of the committee's responsibilities and how it carries them out, including its structure, processes, and membership requirements.

Meetings. The frequency of audit committee meetings should be tailored to the responsibilities assigned, but should be at least quarterly. The audit committee should also meet periodically with management, the external auditor, and the head of internal audit, in separate private sessions.

Disclosure requirements

Audit committees should publicly disclose their charter, composition, recommendations not adopted by the board, and nature and amounts of auditor's fees, in audit and non-audit services.

Chapter

8

Managing Government Financial Information

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Managing Government Financial Information

Main Points

8.1 The government has taken some positive steps in response to our previous recommendations but, overall, we find that its progress on the use of improved financial information in departments and agencies, and improvements in its financial information systems supporting that information, continues to be very slow and, thus, unsatisfactory. However, with a commitment to strengthen financial management and control provided in recent announcements, we are optimistic that the necessary financial leadership and capacity will be developed to significantly advance our previous recommendations.

8.2 Success in these efforts will require continued leadership and commitment. With the Office of the Comptroller General of Canada re-established, the newly appointed Comptroller General can now champion this initiative by aggressively advancing the use and timely preparation of accrual financial information, promoting the importance of good financial internal controls, and working to strengthen the comptrollership capacity in departments and agencies. In addition, deputy ministers and senior department and agency financial officials also need to play a critical role in improving the use of accrual financial information and financial internal control systems.

8.3 Integrated and comprehensive internal financial control systems play a significant role in ensuring that high-quality financial information is available for decision making and financial reporting. They should be given a high priority within departments and agencies. However, weaknesses we previously reported in these systems persist, and departments and agencies have been slow to correct them. Departments and agencies must step up their efforts to correct weaknesses in their internal financial control processes.

8.4 The government must also finalize its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common basis of planning, budgeting, and reporting. After several years of examining this issue, it is now time to prepare a way forward. Without definitive direction and guidance on this issue, wider use of improved financial information in decision making will be impeded.

8.5 Finally, the Office of the Comptroller General must resolve all remaining issues regarding the fair presentation of departmental and agency financial statements so that the government can achieve its objective of having all such financial statements audited within five years. Some progress has been made in addressing these issues, but more work is required.

The Treasury Board Secretariat has responded. The Treasury Board of Canada Secretariat agrees with the recommendations, and the responses in the chapter describe current or planned actions to address the recommendations.

The Treasury Board Secretariat is also pleased that the Auditor General has recognized the positive steps that have been taken in response to previous recommendations. It is confident that recent measures taken to strengthen financial management and control will provide a solid foundation for the future.

The reinstatement of the Office of the Comptroller General along with the appointment of a new Comptroller General and professionally accredited departmental comptrollers will bring renewed focus to those areas where progress is needed.

Introduction

Why is financial information and internal control important to the government?

8.6 Financial information is a key part of the government's reporting and decision making and arises from its financial affairs and transactions. For example, as reported in the 2003–04 *Public Accounts of Canada,* the government raised almost $200 billion in revenue, incurred expenses of approximately $190 billion, had assets of almost $200 billion, and had liabilities of about $700 billion. Departments and agencies use this information when monitoring the delivery of programs and services, exercising stewardship over resources for which they are responsible, supporting decisions, managing risks within the organization, and reporting on the department and agency financial and operating results.

8.7 Under accrual accounting, these transactions and other economic events are recognized when they occur, rather than when cash or its equivalent is received or paid. Expenses are recorded in the period when the goods or services are consumed, revenues are recorded in the periods to which they pertain, and the multi-year economic benefits associated with capital assets are recognized in the period in which they are used.

8.8 Accrual financial information helps users appreciate the full financial scope of government—the resources, obligations, financing, costs, and impacts of its activities, including the costs of consuming assets over time. This more complete picture helps legislators hold the government more accountable for the stewardship of its assets, the full costs of its programs, and its ability to meet short-term and long-term financial obligations.

8.9 Internal controls refer to management's action to mitigate risks and achieve objectives. Controls contribute to this goal by

- safeguarding assets;
- reducing the risk that data may be incorrect or corrupt;
- ensuring proper authorization of transactions and compliance with policies, procedures, laws, and regulations; and
- ensuring the economical and efficient use of resources.

8.10 Complete financial information and strong internal controls are vital for achieving results for Canadians. Integrating financial and non-financial information into decision making, establishing effective financial information systems and controls throughout government, and establishing financial policies and procedures all lead to improving stewardship in government.

8.11 As managers become more aware of the complete picture of their financial performance (all costs, revenues, assets, and liabilities), they are more inclined to consider the complete cost while making various decisions, such as evaluating the cost-effectiveness of in-house delivery versus contracting for services, the appropriateness of cost recovery policies, and the amounts charged to other departments for services.

8.12 Finally, improved financial information and controls should enable departments and agencies to provide, on a more timely and regular basis, parliamentarians and central agencies with a variety of financial reports that compare actual information (both financial and non-financial) with budgeted or planned information in a manner that is consistent with the preparation of the summary financial statements of the Government of Canada.

What has happened since our last Report?

8.13 Before we published our March 2004 Report, Chapter 6, Managing Government: Using Financial Information, the government presented its 12 December 2003 reorganization plan. The plan aimed the Treasury Board of Canada Secretariat's focus toward comptrollership and financial management, including oversight of such matters in departments and agencies. Specifically, the Treasury Board Secretariat will ensure that departments and agencies meet all requirements for expenditure planning, control, and oversight. As well, the reinstatement of a distinct Office of the Comptroller General within the Secretariat enhanced financial accountability as did the announced positions of departmental comptroller. The 2004 Budget and associated press releases re-emphasized these commitments to strengthen financial management and control. Specifically, the government announced that, among other things, it would

- appoint professionally accredited departmental comptrollers to sign-off on all new spending initiatives in every government department;
- establish professional certification standards for departmental comptrollers by the end of the 2004 calendar year that must be met within three years;
- reorganize and bolster the internal audit function on a government-wide basis to ensure comprehensive audit programs that are based on sound risk analysis of all department activities and that have the authority to delve into every corner of every portfolio;
- provide appropriate tools for effective scrutiny and decision making and introduce modern, timely, and enterprise-wide financial and human resource information systems to track all spending; and
- arrange for the audit of the annual financial statements of all departments and agencies within five years.

8.14 The government also embarked on several additional reviews of its management practices to ensure that performance standards are raised ever higher and that significant savings are generated from operations within four years. The reviews included consideration of matters such as the *Financial Administration Act*, corporate and administrative services, government procurement, and capital asset management.

8.15 The comptroller general is to provide leadership in the renewed area of financial management and stronger financial controls within

departments and agencies. Key duties to accomplish this objective include the following:

- approving the appointment of all departmental comptrollers and providing them with advice and guidance on sound financial management and administrative practices and procedures;
- overseeing all government spending, including the review and sign-off of new spending initiatives;
- modernizing the government's financial management suite of policies; and
- managing the professional development of the financial community, including establishing accreditation and certification standards and advising on financial management modules of the public service learning curriculum.

Focus of the follow-up

8.16 In this chapter, our objective was to determine whether the government is achieving two of its wider financial management and control initiatives:

- improving the quality of financial information produced by new financial information systems, and
- ensuring that such accrual information is used in decision making.

8.17 We also explored the government's progress in addressing accrual budgeting and appropriations at the department level and how selected departments and agencies addressed previously identified weaknesses in internal financial controls and accrual financial information.

8.18 Further details are included at the end of the chapter in **About the Follow-Up**.

Observations and Recommendations

Central and departmental leadership and capacity remain necessary to ensure success

8.19 Our previous chapters on financial management and control have highlighted the importance of leadership in improving the quality and use of the government's financial information. Further, they noted that achieving the necessary cultural change associated with the issues reported in this chapter will require more than providing extra guidance or sharing best practices among departments and agencies. Strong individual leadership from central agencies and senior departmental officials is necessary to reinforce that the government is committed to improving the use of financial information and financial information systems.

8.20 **Role of the Office of the Comptroller General.** In that respect, the recently announced re-instatement of a separate Office of the Comptroller General of Canada and the appointment of the Comptroller General presents an excellent opportunity for the Comptroller General to develop a strategy to

handle his various responsibilities in a way that responds to our recommendations on

- overseeing and monitoring departments' and agencies' actions for improving their financial control systems,
- increasing departments and agencies' professional accounting capacity,
- aggressively advancing the use and timely preparation of accrual financial information in the decision making process, and
- resolving any outstanding issues pertaining to preparation of departmental financial statements.

8.21 In particular, we believe that the Comptroller General should explain fully the significance of the recent announcements regarding the role of departmental comptrollers, their accreditation, and the relationship, if any, with current senior financial officer positions. In that last regard, we understand that consultations with the senior financial community have already begun. However, several senior financial officials within departments and agencies told us that such a position already exists within their organization as do all the identified responsibilities and accountabilities announced to date within the position of the senior financial officer. They also indicated that, given the role already identified for senior financial officers and other relevant guidance, there should only be minor changes expected to that position in order to respond to the objectives announced for departmental comptrollers.

8.22 **Background and expertise of senior management team.** Deputy ministers and senior departmental financial officials also need to play a critical role in improving the use and timely preparation of financial information and the related financial internal control systems. The senior management team of a department or agency, in our opinion, needs to have the necessary backgrounds and/or professional training in all relevant disciplines, including accounting, in order to fulfil this role. This means a balance of expertise and perspectives within the senior management ranks—not just a cadre of professional financial managers.

8.23 A background and training in financial management, including accounting, helps the championing of financial management and control in departments. For that reason, and given the importance of financial capacity in departments and agencies, we updated our 2002 survey of professional accountants holding senior financial officer and senior full-time financial officer positions in 11 of the larger departments and agencies. We discovered that the percentage of incumbents that were professional accountants had increased from 33 percent to 55 percent. As a result, progress is being made but it still falls short of our 2002 comparison, where 80 percent of the senior financial officers in the 10 top revenue generating Canadian public companies were professional accountants.

8.24 The continued leadership and support of senior management, both centrally and within departments and agencies, is crucial to the government's objectives of improved financial information for decision making and improved financial information systems. Without it, these objectives risk

losing momentum and becoming just another passing management fad. For that reason, we are supportive of the Comptroller General's efforts to support the professional development of the government's financial community, which include establishing accreditation and certification standards, advancing the role of internal audit, and understanding the profile and needs of financial officers within government.

8.25 **Recommendation.** The Comptroller General, in conjunction with senior financial officials in departments and agencies, should develop a vision, strategy, and implementation plan with key milestones for promoting financial management and control initiatives. The plan should also include milestones for improving the financial capacity in departments and agencies that are consistent with the government's announced support in this area.

Treasury Board Secretariat's response. Since accepting the position in June 2004, the Comptroller General has made significant progress in advancing the government's plan to strengthen comptrollership. During 2004–05, the Comptroller General will design the organization of the Office of the Comptroller General and begin staffing the new organization with high-calibre professionals so that the Office will be substantially completed by 31 March 2006 and fully completed by 31 March 2007.

At the same time, plans and activities will focus on capacity building and community development, strengthening financial accountability and financial systems across the public service, and creating capacity within the Office of the Comptroller General to conduct audits for small agencies and horizontal audits on behalf of the government.

On 18 November 2004, the President of the Treasury Board announced a multi-year initiative, being developed by the Comptroller General, to strengthen the internal audit function across the federal government. The multi-year initiative will enhance the internal audit capacity across the public sector and introduce standardized, proven audit processes.

In order to have the skilled, well-trained, and developed workforce necessary to strengthen public service management, the Treasury Board Secretariat, in partnership with the Canada School of Public Service, the Public Service Human Resources Management Agency of Canada, and functional communities, will develop a core learning framework to provide clear, consistent, and comprehensive programs to meet the common learning needs of public service managers. In 2004–05, the Secretariat began government-wide consultations on the development of professional certification standards. By the end of the year, the Secretariat plans to have defined and established the standard-setting process and developed certification standards for selected functional communities.

Specific to the financial management community, the Comptroller General has developed a draft vision and strategy for the departmental comptroller. Built around the model of a Chief Financial Officer (CFO), the position would be the single point of accountability for financial management in a department, reporting directly to the Deputy Head for overall performance and functionally to the Comptroller General for professional performance. The vision, which

has been discussed with senior financial management in departments and agencies, includes the proposed roles and responsibilities of the position and its relationship with other key players in departments and the Secretariat. Experience and professional and personal attributes and competencies for the CFO position have been developed and key transition issues identified. The strategy also includes other human resource investment plans for recruiting and developing qualified financial officers to support the CFO.

Improvements in financial internal control systems are needed to support good-quality financial information

8.26 Strong financial internal controls help protect the integrity of the information used for decision making. They also contribute to the safeguarding of resources, accurate and timely reporting of results, and ensuring compliance with relevant authorities.

8.27 Since our Report in December 2002, Chapter 5, Financial Management and Control in the Government of Canada, we have continued to evaluate key financial controls governing selected computer information systems used for financial reporting of government expenses and revenues, assets and liabilities, as well as related management and monitoring controls (see Appendix A). We intend to continue these reviews over the next few years so that eventually all of the key financial systems and applications used for financial reporting in the largest departments and agencies are reviewed.

8.28 **Previously reported weaknesses remain.** In our March 2004 Report, Chapter 6, Managing Government: Using Financial Information, we prioritized those control weaknesses arising from our controls assessment work that we believed should receive particular attention (see Appendix B). While this is neither an all-inclusive list of control weaknesses nor an examination of all other operational system controls that may be present, departments and agencies need to address them, if they exist, within a reasonable period to avoid an impact on the quality and timeliness of information used for their decision making and financial reporting.

8.29 As a result, we expected that a subsequent assessment and review of the progress made by departments and agencies in addressing these control weaknesses would show significant improvements. We also expected that any additional control assessments undertaken by this Office would no longer identify the significant weaknesses previously reported. However, in our most recent reviews we continued to identify the same weaknesses that we reported in our two previous chapters.

8.30 To demonstrate the progress made by departments and agencies in addressing the financial control weaknesses we had previously reported, we reviewed the results of their actions taken in response to the previously identified weaknesses where we had performed the original financial control assessments in 2001 and 2002. The level of progress achieved in the departments and agencies reviewed varies (Exhibit 8.1). While some departments made significant progress in a timely manner, others made limited progress even though many departments and agencies had indicated that they had plans to address these issues.

Exhibit 8.1 Progress made by selected departments and agencies in addressing financial control weaknesses previously identified

These ratings reflect the progress made by a department or agency in addressing the weaknesses identified in our original control assessments that were completed in 2001 and 2002. They are not intended as a comparison of progress between entities, because of the differing quantity, nature and complexity of weaknesses. The ratings are not intended as an overall assessment as to effectiveness and efficiency of internal controls within a particular financial system of a department or agency, nor of the relative manner in which the various system implementations are designed. (See Appendix A for additional details.)

Financial systems for reporting expenses incurred

Departments and agencies	Financial systems	Controls			
		Electronic security	Monitoring	Manual processing	Control features optimization
Agriculture and Agri-Food Canada	SAP	●	●	●	●
Public Works and Government Services Canada	Regional Pay System	no weaknesses reported (NWR)			
	Common Departmental Financial System (CDFS)	●	●	NWR	N/A
Canadian Heritage	SAP	◓	◓	◓	◓
Veterans Affairs Canada	Free-Balance	●	●	NWR	NWR
	General IT Environment	◓	◓	◒	NWR
	Client Service Delivery Network (CSDN)	◒	●	◒	N/A
Canada Revenue Agency	SAP–Corporate Administrative System (CAS) expenditure system*	◒	◓	●	◓

*This financial system at Canada Revenue Agency is a larger installation of SAP that also integrates a human resource module

Financial systems for reporting tax revenue

Agency	Financial systems (revenue reporting systems)	Controls			
		Electronic security	Monitoring	Manual processing	Control features optimization
Canada Revenue Agency	IT environment for the mainframe	◒	◒	◓	N/A
	SAP–revenue ledger (pre-implementation review)	◒	◓	●	◓
	T1 assessment/accounting	◒	◓	●	N/A

Other financial control processes identified in our financial audit of the Public Accounts

Departments	Controls			
	Monitoring	Manual processing	Payroll	Authorities
Agriculture and Agri-Food Canada	NWR	NWR	NWR	●
Canadian Heritage	NWR	NWR	●	◒
Public Works and Government Services Canada	◓	●	NWR	◒
Veterans Affairs Canada	●	◒	◓	◓

● **Significantly addressed.** Most of the original significant audit findings have been fully addressed.

◓ **Satisfactory progress.** Substantial progress has been made in addressing the original audit findings, but some additional action is still required.

◒ **Some progress.** Some progress has been made in addressing the original audit findings, but considerable additional action is still required to achieve the desired results.

○ **Unsatisfactory progress.** Progress has not been made in addressing the original audit findings, and action remains outstanding.

NWR: No weaknesses were reported for this category to the department or agency

8.31 After first identifying the control weaknesses in 2001 and 2002, we expected departments and agencies would have significantly addressed these weaknesses. We are aware, in evaluating the extent of progress achieved, that the control weaknesses identified for each entity differ in terms of quantity, nature, and complexity. Also, the nature, size, and complexity of the systems influence the level of progress achieved. For example, addressing financial control weaknesses related to the financial reporting of tax revenues on an accrual basis at the Canada Revenue Agency can be a significant challenge because agency officials must also consider the impact on many tax assessing sub-systems and be responsible for the entire volume of tax revenue transactions within the government.

8.32 During our review of these control assessments, a senior financial official indicated that one of the key factors contributing to their financial control weaknesses was that the systems and the applications were introduced without a corresponding re-engineering of operating processes within their department. As departments and agencies proceed with the implementation of new systems or substantial upgrades to existing systems, this past experience and our identification of common control weaknesses should be considered.

8.33 We also found that certain departments and agencies that successfully addressed some of the identified weaknesses had done so by improving some of their quality assurance functions. These functions review selected transactions to ensure accuracy and their compliance with significant authorities. For example, Agriculture and Agri-Food Canada is using a process that systematically identifies higher-risk transactions for review prior to payment. As well, samples of lower-risk transactions are selected and reviewed to confirm the adequacy of control processes.

8.34 When we first identified these control weaknesses, we noted that, in our opinion, most of the weaknesses could be resolved in a reasonable period. Thus, we expected more progress to have been achieved. However, certain entities have failed to make addressing these weaknesses a priority, because these systems do not generate the management reports used as the basis for management decision making. Instead, the information is exported to other applications and tools to produce the necessary reports. However, the Canada Revenue Agency has shown significant advancement in this area; it has integrated various corporate administrative systems with its financial expenditure systems. This integrated capacity links finance, administration, and human resource information; provides for the single capture of most data; and produces almost all management financial reports.

8.35 The government's challenge is to ensure that all departments and agencies focus on the different types of control weaknesses and how to effectively implement the changes in their management processes so that their financial information is improved.

8.36 **Importance of internal audit.** As we stated in our November 2004 Report, Chapter 1, Internal Audit in Departments and Agencies, the internal audit function is an important element in enabling deputy heads to ensure

that their departments have an effective internal control system. Internal auditors conduct risk-based audits and identify, where necessary, improvements in an organization's risk management strategy and practices, in its management control framework, and the integrity of the information systems it uses for decision making and reporting. As an example, in our controls assessment work with the Canada Revenue Agency, we conducted our review of key controls jointly with the Agency's internal audit function.

8.37 **Recommendation.** The Office of the Comptroller General, in co-operation with departmental and agency management, internal audit groups, and audit committees, should ensure that departments and agencies identify and address the internal control weaknesses in financial information systems within a reasonable period.

Treasury Board Secretariat's response. The Office of the Comptroller General is following up with those departments and agencies reporting significant weaknesses in the financial control assessments done by the Office of the Auditor General.

The Office of the Comptroller General will also communicate to all departments and agencies that have not yet been assessed, information on the weaknesses that have been found to be common to many of the assessed departments. The Office will strongly encourage departments and agencies to be proactive in addressing these weaknesses.

As an initial step, the Office of the Auditor General was invited to brief all senior full-time financial officers on the objectives and common findings of their control assessments at a recent conference.

Advancement of the accrual budgeting and appropriations issue is critical

8.38 Previous chapters on financial management and control have highlighted the lack of progress in addressing accrual-based budgeting and appropriations at the department and agency level. The Standing Committee on Public Accounts has continued to support our recommendations on accrual budgeting and appropriations (see Appendix C) and has repeatedly urged the Treasury Board Secretariat to act on this issue. After several years of studying this issue, we expected the Treasury Board Secretariat to have developed and begun implementing an appropriate action plan.

8.39 **Other jurisdictions have moved forward.** As outlined in this chapter, our interviews with senior financial officials confirm that the lack of accrual-based budgeting and appropriations creates a disincentive for departments to use accrual-based financial information as part of their regular decision-making processes. As a result, we examined the practices of other jurisdictions. We found that Australia, New Zealand, the United Kingdom, and several Canadian provinces and territories (namely British Columbia, Alberta, and the Northwest Territories) have studied the issue, developed a position, and implemented an accrual budgeting and appropriations process that was appropriate for their particular needs.

8.40 **The federal government continues to study implementation.** However, the federal government still has not yet concluded its study of accrual budgeting and appropriations even though it has advanced various elements of that study since our last Report. For example, it has consulted with departments and agencies to obtain their perspectives on possible implementation strategies and has explored the impact of implementing accrual budgeting and appropriations for capital assets and the annual reference level update exercise. Progress, however, has been very slow and few resources have been assigned to the task.

8.41 We recognize that there are challenges with accrual budgeting and appropriations and that a department's annual cash requirements will continue to be important information for Parliament, but we cannot understand why the government has not moved beyond the study of this issue. We also understand that there is no international consensus on this issue, but other jurisdictions seem able to conclude on this matter and, in our opinion, Parliament would be better served if it also received full program cost information based on accrual concepts as part of the estimates and appropriations process. This approach would ensure that Parliament received information comparable with the accrual-based information included in the *Public Accounts of Canada* and the government-wide budget. Furthermore, the information that managers and Parliament use in their decision making would be on the same basis as other external financial reporting of government operations.

8.42 As previously stated, we believe that until government-wide and departmental budgeting and financial reporting are put on a common accrual basis, the government will not achieve its objective of having improved accrual-based financial information used in its decision making.

8.43 **Recommendation.** The Treasury Board of Canada Secretariat should promptly complete its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common accrual basis of planning, budgeting, and reporting.

Treasury Board Secretariat's response. Because the impacts of adopting accrual budgeting and appropriations are major and far-reaching, the Secretariat continues to believe that a prudent and thorough approach to introducing changes in budgeting or appropriations is the most appropriate approach. Although the rate of change is slower than the Office of the Auditor General would like, progress is being made in the area of accrual budgeting.

The Secretariat has recently completed, and will soon present to the Treasury Board, its study of capital asset management. A specific recommendation of this study is to introduce the application of accrual budgeting to capital planning and management. Contingent upon the quality of the long-term asset plan and departmental performance, selected pilot departments would be provided non-lapsing asset funding over a three- to five-year time frame. Eligible departments must have a long-term asset plan conforming to a new

long-term asset management policy and display the resources on an accrual and a cash basis

The Treasury Board Secretariat is currently examining the feasibility of running next year's Annual Reference Level Update exercise on an accrual basis as well as the cash basis on which it is presently based. Achievement of this objective would represent the most significant step yet taken toward across-the-board implementation of accrual budgeting. A specific objective would be for the Treasury Board to approve reference levels for all departments and agencies on an accrual as well as a cash basis. This should represent substantial movement to address the Office of the Auditor General's specific concern that expenditure authorities provided solely on a cash basis are an impediment to departments' full incorporation of accrual information into their financial planning and management.

Accrual financial information must become more than a year-end exercise

8.44 The implementation of new financial information systems and improved financial information within departments and agencies was never intended solely for the purpose of preparing year-end financial results and the summary financial statements of the Government of Canada. Although such information has been incorporated in the preparation of the government-wide budget and periodic monitoring of government-wide results, we expected departments and agencies to have integrated such information into their normal decision-making processes and interim financial reporting activities. In other words, we expected that accrual financial information would be used by departments and agencies throughout the year.

8.45 The Treasury Board Secretariat's response to our March 2004 chapter supported that expectation. The Secretariat noted that Treasury Board submissions and memoranda to Cabinet required both cash-based and accrual information. The accrual information would, in the Secretariat's opinion, have to become part of the process of preparing these documents and, therefore, considered in decision making.

8.46 **Accrual information remains largely a year-end exercise.** As a result, we discussed the role of accrual financial information with senior financial officials in departments and agencies that we selected for examination (see **About the Follow-Up** at the end of the chapter). We reviewed a selection of internal interim financial reports prepared for those officials as well as a sample of Treasury Board submissions prepared by those departments and agencies. We concluded that those departments and agencies use accrual financial information mostly at year-end when preparing financial information for inclusion in the summary financial statements of the government.

8.47 Senior financial officials within those departments and agencies supported our conclusion and our similar concerns from previous chapters. Without a consistent use of accrual financial information throughout all

aspects of government financial operations, they saw little need for that type of information other than as part of the year-end summary financial statement reporting process.

8.48 Other comments received from members of the senior financial community in departments and agencies that may explain the limited use of accrual financial information included the following:

- Accrual accounting was largely implemented as an accounting exercise and not a management exercise; therefore, accrual financial information was not a priority for anyone other than financial managers and then, only at year-end.
- There is a learning curve because many operational managers do not understand the benefits of accrual accounting. Although they may know many of the theoretical concepts, they need additional training and practice to apply the concepts within their department or agency.
- Other than year-end financial reporting for the summary financial statements, ongoing operations of departments and agencies are not managed on an accrual basis. Managers' concerns and, thus, their measure of success in most situations is ensuring that budget information is properly input into the expenditure management system of the government, that expenditures against that budget are properly authorized and recorded, and that regular reports demonstrate a department's or agency's total expenditures against its budget—information that is mostly cash-based and primarily adjusted to an accrual basis at year-end.
- Many departments and agencies are largely responsible for only employee salaries and a selection of grants and contributions programs. The impact of accrual accounting in such situations is minor and limited largely to which period to record year-end transactions. Accrual financial information in those cases is not particularly revolutionary.
- Accrual financial information is seen as most helpful to those departments and agencies with large numbers of capital assets—those in which it is frequently important, for example, to consider whether to purchase or build a particular asset.

8.49 Our review of certain interim financial reports prepared by the departments and agencies that we selected for examination confirmed many of our concerns about the limited use of accrual financial information. Most of the reports were largely comparing cash expenditures with cash budgets without any information that addressed expenses and accrual budgets.

8.50 Our review of Treasury Board submissions and related documents was somewhat more promising. However, we found that accrual financial information was only used in new proposals, as required by the Treasury Board Secretariat, if the accrual information was or would be different than cash-based information.

8.51 While our audit work identified limited use of accrual financial information within departments and agencies, we did discover some good

examples of its use that we believe demonstrate how it can help improve information for decision making (see case study, How accrual financial information improves information for decision making).

How accrual financial information improves information for decision making

National Defence. National Defence manages a significant number of tangible capital assets including armoured vehicles, naval vessels, aircraft, and helicopters. All of these assets contribute to the defence of Canada and Canadian interests. The original cost of these assets is recorded in the Public Accounts of Canada at approximately $44 billion. After years of amortization, the net book value of the assets is approximately $26 billion.

Accrual accounting gave the Department, for the first time, complete financial information on the cost and estimated amortization of its tangible capital assets. Consequently, it allowed National Defence to analyze the effect of this information on its overall goals, objectives, and costs of service.

National Defence is now comparing its original investment and its annual amortization and related operating costs with

- those of defence organizations in other countries, and
- the cost of replacing related assets and the operating and amortization costs of the newer assets.

The Department has a better understanding of the cost of maintaining its assets and can decide whether it should repair and maintain assets, replace the assets, or take some out of service.

Veterans Affairs Canada. Veterans Affairs Canada provides veterans and their dependants with compensation for disabilities and lost economic opportunities, and with health and social programs that honour the sacrifices of veterans.

The introduction of accrual accounting required the Department to change the way benefits to veterans were recorded in order to be consistent with the accrual accounting approach for pensions and other employee future benefits. The full cost of veteran benefits is now recognized in the year in which the benefit is earned or changed and not when it is paid in cash.

Recently, the Department amended the benefits it provides to veterans' survivors. It analyzed the cost of these amendments by considering the impact on its future cash flows and by evaluating the impact of those future cash flows on an accrual basis of accounting (i.e. the discounted cash flow of all future benefits). Initial results indicated that the cost of amending the benefit would be a substantial expense for the year in which the change was made and not fully consistent with other government fiscal objectives.

To address this cost issue, Veterans Affairs, in conjunction with other stakeholders, examined other veterans' benefits that had been identified for revision and highlighted savings by amending or modifying admissibility requirements for those benefits. It examined the future savings and found that the savings were similar to the incremental costs of amending survivors' benefits. By making both changes, the net impact of the changes was limited to approximately $50 million, as outlined in Note 6 to the summary financial statements of the Government of Canada, and the amendments were undertaken for the benefit of veterans and their survivors.

The Department and government had a better understanding of the costs of these programs and the components of the related liability—the full cost was considered as opposed to just the annual cash flow impact.

8.52 In addition, our audit of the government's summary financial statements further supported our observations that accrual financial information remains largely a year-end exercise. We identified several errors in the application of the government's accrual accounting policies. We also found instances of departments and agencies failing to consider aspects of accrual accounting concepts for their assets and liabilities that they didn't correct until quite late in their financial statement preparation processes: for example, expenses recorded in the wrong fiscal period and the impact of the removal of assets from service.

8.53 Although none of these latter matters was sufficient to affect our conclusion on the fair presentation of the summary financial statements, they illustrate that departments and agencies are not yet considering accrual financial information as part of their routine management information practices but rather as part of the year-end exercise of preparing financial submissions for the summary financial statements of the Government of Canada. More timely and thorough reviews of the financial information produced by the underlying systems within departments and agencies need to be carried out so that management can address these issues before the year-end and so that financial information available for decision making and external financial reporting to Parliament can be accelerated.

Specific challenges related to financial reporting of accrual financial information still need to be addressed

8.54 As part of our audit of the summary financial statements of the Government of Canada, we continue to report the need for improvements in the financial information and financial reporting at the Canada Revenue Agency and the Department of National Defence as it relates to their respective responsibilities for the financial reporting of tax revenues/receivables and inventories on an accrual basis of accounting (see Canada Revenue Agency needs to improve financial reporting practices for tax revenues and receivables and National Defence needs to improve inventory costing practices).

8.55 While the implementation of accrual accounting for tax revenues/receivables and inventory was a significant and challenging task for the government and still requires a significant effort by the respective agency and department, both situations continue to highlight the need for all departments and agencies to continue to improve the quality of their accrual financial information and to make the preparation of such information a part of their regular periodic financial reporting practice and not simply a year-end exercise.

Canada Revenue Agency needs to improve its accrual financial reporting practices for tax revenues and receivables

The Canada Revenue Agency manages $56 billion in federal receivables, $33 billion in payables, and an estimated allowance of $7 billion for receivables that will likely be uncollectible (doubtful accounts). With these figures, the Agency also manages the revenues that the Canada Border Services Agency receives from customs and border operations.

The Agency primarily determines the tax accrual figures based on tax assessment information derived from various tax program systems and then supplements that information with estimates of tax revenue earned in the period based on payments made by taxpayers. These taxation systems, however, were never designed as accounting systems for the accrual of tax revenues. Extensive data manipulation, manual processing, reconciliations of information from various sources, and analysis of tax collectability are needed to prepare the tax revenue information for inclusion in the summary financial statements. Properly reporting tax revenues and receivables and making an allowance for doubtful accounts each year is important for assessing the amount of federal revenues to be reported and the cost of managing all of the government's tax receivables.

During our audit of the government's 2002–03 summary financial statements, we first noted that for some types of tax revenue, there were significant differences between the amounts in the Agency's summary financial records and the totals of individual detailed records from underlying tax program systems constituting that balance. Following analysis of these differences, the Agency decided to make an adjustment to its summary financial records. Unexpected differences such as those, however, are usually an indication of a problem with financial reporting practices. As a result, although these adjustments were made, we remained concerned that significant differences could recur each year.

We also noted in that audit that the Agency was not consistent in the way it evaluated the allowance for doubtful accounts. At the time, the Agency re-evaluated the estimate of the allowance for doubtful accounts, and we were able to conclude that the allowance was fairly presented, in all material respects, in the summary financial statements.

Our recent audit of the government's summary financial statements noted that the Canada Revenue Agency had implemented several improvements. The Agency completed a detailed review of the underlying causes of the differences in tax revenue amounts that supported its preliminary conclusion from the prior year and developed a multi-year plan to introduce accounting sub-ledgers for each of its tax revenue streams. The Agency also increased the extent that it reviewed the estimates of the allowance for doubtful accounts, improved the communication and training used to evaluate the allowance for doubtful accounts, and improved the consistency with which it evaluated collectibility.

However, our current year's audit work continued to identify differences between the summary and detailed records of some types of tax revenue. Further reviews of these differences by the Agency indicated that they resulted from causes that had not previously been identified. The Agency made corrections for these errors during the current year and reduced the overall amount of the unexplained difference, which enabled us to conclude that the tax revenue figures were fairly presented in all material respects in the summary financial statements of the Government of Canada. Still, the adjustments were made as a part of the year-end exercise of finalizing the financial accounts of the government. The regular financial management practices of the Agency did not identify or rectify these problems.

National Defence needs to improve inventory costing practices

Inventories at National Defence account for the largest part of the government's $6.1 billion in inventories. They include such items as ammunition and consumable supplies like uniforms and machine tools. Historically, the Department's inventory systems were designed to maintain a record of quantities and not regularly determine the monetary value of the inventory. Inventory purchases were simply expensed when purchased.

During our audit of the 2002–03 summary financial statements, we found that National Defence's inventory systems and costing practices did not provide accurate cost information on its inventory items. As a result, the Department could not independently support the prices of its inventory.

In our audit of the summary financial statements and our observations in the 2003-04 Public Accounts of Canada, we noted that the Department had instituted the following improvements:

- reviews of some of its older costs for items such as munitions and the required corrections,
- improvement of the controls that detect errors when inventory is recorded,
- establishment of an interdepartmental committee to discuss ongoing challenges in improving inventory records, and
- improvement of the information system that monitors inventory inflows and outflows.

However, we continue to note errors in the way the inventory is valued; for example, some of the costs of the inventory were not properly supported and current year transactions (purchases, usage, and obsolescence) were not properly recorded. Most of these errors were corrected by National Defence, and we were able to conclude that the inventory figures were fairly presented, in all material respects, in the summary financial statements of the Government of Canada. However, these corrections were largely made as part of the Department's year-end effort to prepare its financial submissions and not as part of its regular financial management practices.

8.56 **Recommendation.** The Office of the Comptroller General, in conjunction with department and agency deputy ministers, should ensure that departments and agencies have strategies, where applicable, for improving the quality and use of accrual financial information that supports their regular financial reporting, analysis, and decision-making process.

Treasury Board Secretariat's response. Accrual financial information is being used throughout the year, from the preparation of the monthly Fiscal Monitor to the requirement, as noted in the chapter, for accrual information in memoranda to Cabinet and Treasury Board submissions for new funding. Departments and agencies are required to submit monthly financial information on an accrual basis in trial balances sent to the Receiver General. Senior financial management in departments and agencies must attest to the completeness and accuracy of the financial information in these monthly trial balances, and the Receiver General issues reports on the data quality.

The requirement for departments and agencies to provide accrual financial information is being expanded. The Treasury Board Secretariat is currently working with the Department of Finance and the Privy Council Office on the guidance needed for the inclusion of accrual financial information in all

memoranda to Cabinet and Treasury Board submissions, not just those for new funding. As well, the Treasury Board Secretariat is examining the feasibility of requiring departments to provide financial plans on both a cash and accrual basis for the 2006–07 Annual Reference Level Update exercise.

Accrual accounting, implemented as part of the Financial Information Strategy, was not promoted as a year-end exercise. Much effort was spent working with managers in departments and agencies promoting the use of accrual financial information in decision making. However, an understanding of the importance and benefits of accrual financial information in the departmental decision-making process is a significant cultural change.

Central agency requirements for accrual financial information create the need to develop the capacity in departments and agencies to provide that information and foster a greater understanding of the importance and benefits of the information in the decision-making process. As evidenced in the case study in the chapter, there are signs that departmental management is beginning to understand the importance of accrual information. Other indications are that some departments are introducing quarterly financial statements for internal management purposes.

Improved departmental financial statements can advance the use of improved financial information

8.57 Part of the Treasury Board Secretariat's accounting policy framework requires departments and agencies to prepare auditable annual financial statements. Such financial statements, if prepared on an accrual basis of accounting, support improved financial management because they fully and accurately report the financial affairs of departments and agencies. For several years, some departmental corporations and most separate agencies have had their financial statements prepared on an accrual basis of accounting and subsequently audited. However, a large number of departments have not, in our opinion, reached the point of having financial statements prepared on a basis that would withstand an independent audit.

8.58 Senior financial officials said that auditing departmental financial statements would confirm the accuracy and completeness of the accrual financial information that is provided to senior management and might advance the use of accrual financial information for decision making. Therefore, there is clear support within departments and agencies to advance this issue as quickly as possible.

8.59 Audited financial statements for departments within five years. Given the importance of departmental financial statements and because the government announced in March 2004 that within five years all departments will have their annual financial statements audited, we expected that the government would have accelerated its resolution of any related outstanding issues and developed an approach to implement this initiative. We reviewed a sample of the unaudited departmental financial statements to assess whether they contained the elements that we considered necessary for fair presentation. We also discussed the preparation of these financial statements

with senior financial officials within selected departments. Finally, we met with the staff of the Office of the Comptroller General of Canada to assess their plans to enable all departments and agencies to have audited financial statements within five years.

8.60 Our audit work identified several improvements:

- the transfer of several balances to departments and agencies that were traditionally controlled by central agencies; for instance, allowances for certain loans, investments, and advances;
- updated guidance to departments and agencies on improving their financial statements; and
- the publication of financial statements in departmental performance reports where the department or agency had satisfied all elements necessary for fair presentation.

8.61 Despite these improvements, the unaudited financial statements still do not provide accurate and reliable information on program costs and overall financial position because certain significant items still remain under the control of central agencies, including provisions for severance liabilities, contingent liabilities, and environmental liabilities. As a result, users of these unaudited financial statements do not get a complete picture of the department's or agency's costs of activities, assets, and liabilities and are, therefore, making decisions without complete information.

8.62 The Office of the Comptroller General understands that despite the improvements achieved, additional information is required to ensure that these financial statements are complete.

8.63 **Recommendation.** The Office of the Comptroller General should promptly resolve any outstanding issues regarding departmental financial statements and develop a plan to achieve the commitment of having audited financial statements within five years.

Treasury Board Secretariat's response. As noted in the chapter, the financial statements of agents of Parliament and those of most departmental corporations are currently audited and published. As well, the remaining departments and agencies are preparing annual financial statements on an accrual basis.

Each year since the implementation of the Financial Information Strategy on 1 April 2001, the Treasury Board Secretariat has devolved certain centrally recorded items to departments and agencies for inclusion in their financial statements. For the 2004–05 fiscal year, the Treasury Board Secretariat is devolving the recording of the allowances on additional loans, investments, and advances, as well as the accounting for environmental liabilities, only recently required to be reported in the summary financial statements of the Government of Canada.

In each case, the Treasury Board Secretariat must co-ordinate with the Receiver General and the specific department or agency to ensure that the initial accounting to devolve the balance is done accurately, and that the

department or agency has the processes and capacity in place to continue accounting for the item in a timely and accurate fashion.

Of the centrally recorded items not yet devolved, the Treasury Board Secretariat has identified those items for which devolution is appropriate. Over the next few months, the Treasury Board Secretariat will meet with the Office of the Auditor General to discuss its plans as well as the capacity of the Office of the Auditor General to audit the statements of all departments and agencies.

Conclusion

8.64 Although the government continued to make progress in advancing the use of improved financial information in departments and agencies and in improving the quality of the systems supporting that information, we are disappointed that more work is still needed to resolve several outstanding issues.

8.65 The Office of the Comptroller General needs to actively advance the use of accrual financial information and promote good financial internal controls within government by

- monitoring and influencing departmental use of accrual-based financial information,
- developing a strategy to increase the representation of professional accountants in the senior financial positions within departments and agencies, and
- developing a plan to resolve any outstanding issues regarding departmental financial statements so as to achieve the commitment of having audited financial statements within five years.

8.66 Departments and agencies must improve their use of accrual-based financial information so that it becomes more than a year-end exercise that they undertake to comply with directives for preparing the summary financial statements of the Government of Canada. Departments and agencies must also strengthen their financial internal control systems, paying particular attention to electronic security controls, monitoring practices, and the integration of manual and electronic processing controls.

8.67 Finally, it remains essential that the government resolve the issue of accrual budgeting and appropriations at the department level. Although this complex issue needs to be considered carefully, the government has been studying it for many years and has made little progress. In our view, until government-wide and departmental budgeting and financial reporting are put on a common basis, the government will not be able to make the most effective use of its financial information. Departments and agencies will continue to see their performance measured against a cash budget and a cash appropriation and, therefore, will have little motivation to fully utilize accrual financial information as part of their regular management decision-making and reporting processes.

About the Follow-Up

Objective

The objective of this follow-up was to determine whether the government has made progress in achieving two of its wider financial management and control initiatives: improved financial information used in decision making along with improved quality of that information through the introduction of new financial information systems.

Scope and approach

The scope of the follow-up includes the larger departments and agencies[1] for which we reviewed financial information systems as part of our financial audit of the summary financial statements of the Government of Canada and for which we had completed a follow-up of those reviews. These departments and agencies included the following:

- Canadian Heritage,
- Agriculture and Agri-Food Canada,
- Veterans Affairs Canada, and
- Public Works and Government Services Canada.

In addition, our audit scope included the Treasury Board Secretariat where considerable responsibility for government wide financial accounting, management, and control issues rests. The Canada Revenue Agency and National Defence were included in our audit scope but only to the extent of monitoring significant issues related to the implementation of accrual accounting that had previously been reported: for example, the accounting for tax revenues and consumable inventories respectively and the follow-up of any financial information systems reviews.

This chapter includes issues that arose during our audit of the summary financial statements of the Government of Canada. Consequently, our audit approach relied on the nature, scope, and extent of that audit work. The audit of the summary financial statements was conducted in accordance with Canadian generally accepted auditing standards. We assessed whether the summary financial statements were fairly presented in accordance with the government's stated accounting policies. The procedures we followed included testing of transactions and account balances, performing analyses, confirming year-end balances with third parties, reviewing significant internal controls as necessary, and discussing matters with government officials.

In addition to the audit work performed for the summary financial statement audit, we conducted interviews with senior officials regarding the use of accrual financial information, reviewed documents that contained financial information used to support financial decisions within government, and reviewed other audit work done by the Office of the Auditor General of Canada in the area of financial management and control in the government

Criteria

In respect of those departments and agencies selected for examination, we expected, where applicable, the following:

- Departments and agencies would have improved their internal financial control systems and addressed all significant weaknesses we identified in 2001 and 2002.
- Departments and agencies would have integrated accrual financial information into their regular decision making.
- Departments and agencies would have increased their professional accounting capacity, when appropriate, and developed appropriate plans to implement the new oversight responsibilities of the departmental comptroller.

1. Departments and agencies—Refers to only the specific department's or agency's operations as identified in the Government's Expenditure Plan and Main Estimates and not all of the other agencies or entities that may report to the selected department or agency through the government's reporting processes.

- The Treasury Board Secretariat would have developed a strategy to oversee and monitor actions within departments to improve financial control systems, professional accounting capacity, the use of accrual financial information, and the preparation of departmental financial statements.
- The Treasury Board Secretariat would have concluded its study of accrual-based budgeting and appropriations and developed an implementation plan.
- The Treasury Board Secretariat would have finished developing the approach to implement the remaining accrual accounting policies for departments and agencies and transferred the remainder of the central accounting processes that will allow for complete departmental financial statements.

Audit team

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Sophie Boudreau

Appendix A Scope of controls assessment work

Since our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness, we have continued to evaluate certain financial controls governing selected computer information systems, along with the related management and monitoring controls. Our objective was to determine the extent to which the selected financial internal controls of various departments and agencies were sufficient to contribute to the safeguarding of assets and the accuracy, completeness, and proper authorization of financial information related to our audit of the summary financial statements of the Government of Canada. However, the scope of our audit work was neither designed nor sufficient to express an opinion as to the effectiveness or efficiency of all internal controls within the selected departments and agencies nor to compare one entity's progress against another. The scope of our audit also may not identify all matters that might be of interest to management.

	Selected financial information (FIS) strategy system reviewed			Legacy systems[1] to be reviewed	
Entity	Year of initial assessment	Number of systems	Year of follow-up	Year of initial assessment	Number of systems
Agriculture and Agri-Food Canada	2001	1	2004	2004	2
				2005	1
Canada Revenue Agency	2001	2	2004	2003	2
	2002	2		2004	2
				2005	2
Canadian Heritage	2001	1	2004	2003	1
Public Works and Government Services Canada	2002	2	2004	2004	3
Veterans Affairs Canada	2002	2	2004	none	
Department of Foreign Affairs and International Trade	2002	1		2005	1
Indian and Northern Affairs Canada	2002	1		2002	2
Transport Canada	2003	1		2004	2
				2005	3
Citizenship and Immigration	2003	1		2005	2
Health Canada	2003	1		2005	2
Industry Canada	2003	1		2005	2
National Defence	2004	1		2004	3
				2005	6
Fisheries and Oceans Canada	2004	1		2005	6
Canadian International Development Agency	2004	1		none	
Royal Canadian Mounted Police	2004	1		2005	1
Correctional Services	2004	1		none	
Human Resources Development Canada[2]	2004	1		2004	2
				2005	2

[1]Legacy systems are existing systems made up of centralized processing systems. Usually, they are older mainframe and minicomputer information systems that have been running for many years.

[2]HRDC was divided into two entities, Social Development Canada and Human Resources and Skills Development Canada. Both still operate with the same systems and applications as before the reorganization but are now managed within Social Development Canada.

Appendix B Common weaknesses found in many internal financial control systems that need particular attention

Financial systems and processes	Weaknesses	Explanation and implications
Electronic security controls	• User access rights and privileges reflect incompatible duties. • Super user accounts are not sufficiently controlled. • Users have wider system access than required. • Generic user IDs are used, impairs accountability. • Best practices for key security parameters are not being enforced.	Electronic security controls are used to control user access rights and privileges within an electronic financial information system. Lapses in or inadequate electronic security controls could lead to unauthorized access, which can then allow for accidental or intentional corruption or loss of information. This can also result in the integrity of system tables and structures being compromised or in erroneous reports being produced by the systems.
Monitoring controls	• Security administration function does not follow best practices. • Reconciliation of accounts is not being done on a timely basis. • Review of clearing and suspense accounts is not timely. • Policies and procedures for monitoring accounts are not always in place—for example, review of unusual or high-risk transactions and review of key performance measures such as "receivables aging."	The security administration function is shared among many users and not controlled. There are no formal policies and best practices in place, leaving this position at risk. Monitoring controls engage senior management in analyzing the reasonableness of financial information. Differences identified or matters observed must not only be highlighted but investigated and analyzed with corrective action taken. A lack of monitoring controls allows errors to go unnoticed, thereby compromising data accuracy and validity as well as increasing the risk of loss and/or corruption of data.
Control features optimization	• Many controls features inherent in the new financial systems are not being used.	Not taking full advantage of these financial control features results in lost opportunity to increase efficiency and effectiveness of the operations. Options not optimized include functionalities to ensure each payment is matched to a requisition and evidence of receipt of goods/services and report generation. Not using built-in controls could reduce the consistency of the application of the controls. Also new financial systems are often used to simply compile results produced from existing systems. In some cases, two or more systems are operating where integration may be possible. This approach adds to the complexity and cost of maintaining financial information. There is also additional room for error if separate systems are maintained.
Manual processing controls	• Segregation of duties is inadequate. • Documentation on policies and procedures is not being prepared/reviewed. • Quality assurance of the account verification process is limited.	Modern control frameworks should allow for proper integration of manual processing controls within an electronic framework. Manual controls are less systematic and less comprehensive in their application than electronic controls. Bypassing the electronic framework increases the risk that data values will remain unchecked, be omitted, or result in duplicate information or other errors.

Financial systems and processes	Weaknesses	Explanation and implications
Selected authorities controls	Payments are being certified without • documentation of having received the goods, • proper delegation of signing authority, and • authorization.	Section 34 of the *Financial Administration Act* requires that proper authorization be obtained and that goods or services are received prior to any payment made. Section 33 of the Act requires that proper authorization be obtained prior to any requisition for a payment out of the Consolidated Revenue Fund and the subsequent charge against appropriations. Without proper controls, the government does not have assurance that payments are made only for goods or services that have been received.

Appendix C Standing Committee on Public Accounts: Recommendations on accrual appropriations/budgeting and the government's response

Report date	Recommendation	Government response
December 1998	The Treasury Board Secretariat should complete its consultations with its stakeholders as quickly as possible in order to determine the best possible options to move the appropriations (supply) process to full accrual basis.	Progress is slower than anticipated. Response to a consultation paper is expected by 10 March 2000, from which recommendations to the government will be made in the following two or three months.
March 2000	The Treasury Board Secretariat should complete its consultations with departments and agencies on moving to accrual appropriations. Once the consultations are completed, the Treasury Board Secretariat should inform Parliament and the Public Accounts Committee in writing of its final decision and recommendations to the government on moving to accrual appropriations.	Responses to the consultation paper have been received and are being compiled and analyzed. Completion of the analysis is expected by September 2000, although further review of accrual-based budgeting and its relationship with appropriations may be required.
March 2001	The Treasury Board Secretariat should complete its consultations with parliamentarians aimed at determining the best possible options to convert the appropriations (supply) process to a full accrual basis and report the results to the House of Commons by 31 March 2002; the Government of Canada should move to an accrual-based system of appropriations (supply) by 1 April 2003.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. Any decision made will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
May 2001	The Treasury Board Secretariat should undertake and complete the required studies and consultations on full accrual-based appropriations, and it should prepare a set of proposals and alternatives to be presented to the House of Commons Standing Committee on Public Accounts, no later than 31 March 2002.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. The decisions made respecting any contemplated changes to our budgeting and appropriations practices will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
December 2002	The government should adopt the integration of full accrual-based budgeting and appropriations into the Canadian Expenditure Management System and advise the Public Accounts Committee when the decision has been made. Once the decision is made to move toward full accrual-based budgeting and appropriations, the Treasury Board Secretariat should immediately prepare an action plan together with an implementation timeframe and table both these documents with the Public Accounts Committee.	Adopting the integration of full accrual-based budgeting and appropriations into the Expenditure Management System could have far reaching implications for government and for Parliament. Unlike accrual accounting, there is not international consensus on the adoption of accrual budgeting. Those countries that have implemented accrual budgeting have adopted specific accrual tools to suit their specific need and to help them implement much broader reforms. Moreover, some countries have indicated that their accrual budgeting frameworks are not yet proven and may be subject to change in the context of lessons learned. We intend to learn from their experience.

Source: Adapted from reports of the Standing Committee on Public Accounts

FEBRUARY 2005

A Message from the Auditor General of Canada

Chapter 1 Information Technology Security

Chapter 2 Transport Canada—Overseeing the National Airports System

Chapter 3 Modernization of Human Resources Management: Managing the Reforms

Chapter 4 Accountability of Foundations

Chapter 5 Canadian International Development Agency—Financial Compliance Audits and Managing Contracts and Contributions

Chapter 6 Canadian Nuclear Safety Commission—Power Reactor Regulation

Chapter 7 Governance of Crown Corporations

Chapter 8 Managing Government: Financial Information



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to the House of Commons

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The May 2006 Report of the Auditor General of Canada comprises eight chapters and a Message from the Auditor General.

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Auditor General of Canada
Vérificatrice générale du Canada

To the Honourable Speaker of the House of Commons:

I have the honour to transmit herewith my first Report of 2006 to the House of Commons, which is to be tabled in the House in accordance with the provisions of subsection 7(5) of the *Auditor General Act*.

Sheila Fraser

Sheila Fraser, FCA
Auditor General of Canada

OTTAWA, 16 May 2006

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A Message from the Auditor General of Canada



Sheila Fraser, FCA
Auditor General of Canada

A Message from the Auditor General of Canada

I am pleased to present my fourth Status Report to the House of Commons.

In addition to the Status Report, I am issuing a report entitled Government Decisions Limited Parliament's Control of Public Spending. The issues covered in that report came to our attention during our audit of the Canadian Firearms Program.

As Parliament's auditor, the Office of the Auditor General plays an important role in promoting government accountability and well-managed public administration in Canada. Our performance audits provide parliamentarians with fact-based information they can rely on in their oversight of government spending and performance on behalf of Canadians.

The essence of parliamentary control of the public purse lies in the ability of the House of Commons to establish an annual cap on the amount of money that the government may spend on each of its identified areas of activity and in holding the government to account for respecting those limits on its spending.

The ability of Parliament to exercise control depends on the government's production of good spending estimates in the first place and, at year-end, on the fair presentation of actual spending in departmental accounts. Only if this is done can Parliament be assured that its authority will not normally be exceeded and, in those rare cases when it is, that it will be in a position to exercise its duty of holding the government to account.

Decisions by the government not to seek authority when required, or not to account fully for expenditures against a Vote where an over-expenditure is likely, could be viewed as limiting Parliament's ability to control the public purse.

We found that the Canada Firearms Centre—on the advice of the Treasury Board Secretariat and legal advisors—did not submit Supplementary Estimates in 2003–04, even though it was aware that it was likely to exceed its 2003–04 spending limit authorized by Parliament. Furthermore, it also decided—again on the advice of the Secretariat and legal advisors—not to record as 2003–04 expenditures $21.8 million of costs incurred for the Canadian Firearms Information System II. Had these costs been recorded, the Centre would have exceeded its voted appropriation for that year.

In our opinion, those decisions were contrary to the *Financial Administration Act* and the government's stated accounting policies.

Actions taken to avoid seeking proper authority for supplementary appropriations could be interpreted as a breach of the Standing Orders of the House of Commons. Failure to fully account to Parliament for expenditures against a Vote could also be viewed as an infringement of the privileges of the House of Commons. However, only the House itself can determine whether such a breach has occurred. The Standing Committee on Public Accounts may wish to pursue this matter further if it considers that to be appropriate.

Status Report

Once a year, I prepare a report for Parliament called the Status Report. This report focusses on what the government has done to address recommendations made in a selection of previous performance audits. It answers the question: Does government take action in response to the Auditor General's reports? We look at the steps departments have taken to resolve issues we have reported in the past, and we assess whether progress has been satisfactory, given the complexity of the issues involved and the amount of time the departments have had to act. This report assists parliamentarians in their efforts to hold the government accountable for its stewardship of public funds.

Taken as a whole, the eight chapters in this year's report paint a picture of mixed progress. For half the chapters, we conclude that overall progress has been unsatisfactory. For the other half, we are reporting satisfactory progress, while clearly highlighting the problems that still concern us. This is the case for the chapter on the Canadian Firearms Program. While we are reporting that the Canada Firearms Centre has made satisfactory progress on the single recommendation made in our 2002 audit, we continue to have concerns about the quality of data in the firearms registration database, the development of CFIS II, and the Centre's performance reporting.

For our chapter on the management of programs for First Nations, we undertook work that went beyond our usual follow-up of previous audits. In addition to looking at how well five federal organizations had implemented 37 recommendations on First Nations issues reported between 2000 and 2003, we identified factors that appear to have been critical in successfully implementing our recommendations. We explored the conditions that had contributed to positive action or whose absence had hindered it. We think this knowledge can be used to improve the chronically slow rate of progress on issues that are critical to First Nations communities.

Management of Voted Grants and Contributions

Every year, the government spends about $17.5 billion on voted grants and contributions, which require Parliament's approval through an annual appropriation. When we last reported on the management of grants and contributions in 2001, we noted weaknesses in the way departments assessed applications for funding, managed risk, and exercised financial controls, especially controls over payments to the recipients of funds.

This year we found that, overall, the government has made satisfactory progress in managing grants and contributions. Four of the five departments we looked at clearly document their assessments of funding applications, and they have in place management systems, a risk-based approach to monitoring funded activities, and training for officials working in grants and contributions programs. The sole exception was Indian and Northern Affairs Canada, the largest federal spender on grants and contributions, which has weaknesses in all these areas.

However, departments have not received clear direction on when to use a grant and when to use a contribution in designing programs. Moreover, the available types of transfer payments set out in the Policy on Transfer Payments issued by the Treasury Board do not meet departmental needs. Requirements to establish a program are not clearly linked to the definitions of types of transfer payments. In response, some programs have created types of transfer payments that exhibit elements of both grants and contributions.

Recipients of grants and contributions have expressed concerns about the way departments apply the Policy on Transfer Payments. For example, organizations with long-term projects may have to reapply annually and demonstrate their eligibility for funding, even when they have received grants or contributions year after year and the departments already have the required information. This results in added administrative costs for recipients and wasted time and resources for departments. We found that although some efforts have been made, departments and the Treasury Board Secretariat have yet to streamline their management of grants and contributions in ways that would resolve such concerns.

National Defence—Military Recruiting and Retention

The Canadian military is embarking on a major transformation that includes increasing its regular forces by 5,000 members over the next five years. This expansion has been identified as a priority in order to meet operational demands.

In 2002 we reported that the Department of National Defence was having difficulty both recruiting enough people to meet operational demands and addressing the reasons members were leaving the military, particularly those in some key military occupations. This year we found that, overall, the Department has made satisfactory progress in responding to our recommendations. However, problems remain. The Department has shown some improvement in recruiting the military personnel needed to meet operational requirements, yet it is barely replacing the members who are leaving. While it has recruited about 20,000 new members since our 2002 audit, the number trained and available for duty has increased by only 700.

Recruiting and attrition problems are jeopardizing the Canadian Forces' planned expansion. Faced with a changing Canadian demographic profile, a low level of interest among Canadian youth in joining the military, and increasing military operational demands, the current recruiting and selection process is not meeting the needs of the Canadian Forces. The Department needs to address the problems that prevent it from getting the right number of suitable candidates from which to select recruits.

Further, National Defence forecasts an increase in the number of members who will leave the military over the next 10 years. Because the Department has not measured the impact or tracked the progress of the retention strategy it developed in 2001, it cannot demonstrate that the strategy has helped to increase the trained effective strength or resolve shortages in key military occupations.

National Defence has begun to take military human resources management into account in its long-term strategic planning for the Canadian Forces. However, policies, systems, and practices have yet to reflect the new strategic direction of the Canadian Forces.

National Defence—NATO Flying Training in Canada

In May 1998, National Defence entered into a $2.8 billion, 20-year contract to purchase pilot training as part of the NATO Flying Training in Canada program. With the participation of more foreign nations, this contract has since increased to about $3.4 billion. Our 2002 Status Report noted concerns about the management of both the program and the contract. Because of the contract's restrictive nature and problems with the aircraft, the Department had paid about $65 million for training that was either not available or was not used before the end of December 2001.

Our follow-up audit found that overall, National Defence has made satisfactory progress toward resolving the problems we reported in 2002 and has recently reached an agreement with the contractor to compensate the Crown for the cost of training missed prior to December 2002, which had grown to about $89 million.

However, since December 2002, National Defence has experienced other problems with the program and, as a result, paid about $39 million for flying training that it could not use because too few pilots were enrolled in the program. It appears that the Department has no recourse to recover this loss. We believe that this training shortfall is likely to continue for at least a few more years.

Canadian Firearms Program

In 2002, we reported that we were unable to complete our audit of the costs of the Canadian Firearms Program, because the financial information was unreliable and did not fairly present the net costs of the program. We also said that the Department of Justice was not giving Parliament enough information to allow for effective scrutiny of the program or to explain the dramatic increase in its costs. We made only one recommendation in 2002: The Department of Justice should rectify these gaps in financial reporting.

Our follow-up audit found that the Canada Firearms Centre, now a separate agency, has made satisfactory progress in implementing that recommendation, except in accounting for the costs of the new information system it is developing. In two cases, significant costs of the Canadian Firearms Information System (CFIS) were not recorded in the correct fiscal year, contrary to government policies for appropriation accounting. Had the costs been recorded correctly, in 2002–03 the Centre would have exceeded by $17.1 million the spending limit stated by the Minister of Justice. Because the 2002–03 costs were not recorded until 2003–04, recording the new costs for 2003–04 in that year would have required additional funding through the use of Supplementary Estimates.

The new management team appointed to the Canada Firearms Centre in 2003 has started to address many of the organizational issues facing the Centre. However, problems remain. The Centre has not assessed the quality of the data in the firearms registration database and does not know how many of its records are incomplete. Its plans for resolving concerns about data quality hinge on a network of volunteer verifiers. We have several concerns about the operations of this network.

Before the new management team arrived in 2003, the contracts for the CFIS were poorly managed. The system being developed to replace it, CFIS II, is significantly over budget. Some of the increased costs are due to the fact that development began before legislation and regulations were in place. Project delays have contributed to about one third of the total cost, now expected to be at least $90 million.

The Centre's performance reports do not give Parliament a complete picture of how well the licensing and registration activities are performing. The Centre has no formal process for following up with law enforcement on its licence refusals and revocations, and therefore it cannot report on their impact.

Managing Government: Financial Information

Every year, the federal government handles billions of dollars of taxpayers' money. Strong internal financial controls and complete financial information are vital if the government is to prudently manage its revenues and expenses. Gaps or weaknesses in financial controls can lead to inaccurate and unreliable financial information, poor control over physical assets, and improperly authorized financial transactions. Without good controls, an organization risks being unable to prevent or detect failures to comply with regulations, policies, and procedures.

In the 11 departments and agencies that account for most of the government's revenues and a large part of its expenses, we found progress in improving financial information to be unsatisfactory. With few exceptions, most financial information used in decision making continues to be based primarily on the cash method of accounting. This information provides a less complete and less accurate picture of an organization's financial situation than does information prepared by the accrual method.

Currently, the accrual method of accounting is used mainly at the end of the fiscal year to comply with requirements for preparing the government's summary financial statements. This is chiefly because departments and agencies make little use of accrual financial information as a regular management tool. Financial officials have indicated that departments and agencies will not use accrual financial information effectively until government-wide and departmental budgeting, financial reporting, and appropriations are done on a common basis.

Departments and agencies are slowly taking action to resolve the weaknesses we previously identified in their internal financial controls. In our view, however, until the government has addressed our concerns about the weaknesses that persist, the quality of financial information that departments and agencies use for many of their key decisions will be at risk.

Management of Programs for First Nations

Although the federal government spends billions of dollars a year on programs that address issues affecting First Nations—such as housing, health care, education, and economic development—conditions in many First Nations communities remain significantly below the national average.

Our follow-up audit examined the progress made by five federal organizations in implementing 37 recommendations from past chapters on First Nations issues. The chapters covered housing on reserves, economic development, health care, the food mail program, comprehensive land claims, and reporting requirements for First Nations.

Overall, progress in addressing our recommendations has been unsatisfactory. Although we recognize that the issues are highly complex, federal organizations had agreed with most of the recommendations and had committed to taking action. While we noted satisfactory progress in several areas, they are generally not the areas most important to the lives and well-being of First Nations communities. We found that little had been done, for example, to address the serious problem of mould in houses on reserves, to analyze patterns of prescription drug use and drug-related deaths, to implement comprehensive land claim agreements, to eliminate unnecessary reporting required of First Nations communities, and to address gaps in the Third Party Manager Policy.

During this audit, we identified several factors that appear to have been critical in successfully implementing our recommendations. Progress was more likely to have been satisfactory where programs were well-co-ordinated, received the sustained attention of management, and involved meaningful consultations with First Nations. In many cases, success was linked to the capacity of First Nations to carry out programs in their own communities and the presence of First Nations institutions that supported social and economic development in communities. Further, ensuring that

programs and initiatives were based on appropriate legislation helped to clarify roles and responsibilities, and eligibility issues.

We noted that Indian and Northern Affairs Canada has different roles that create at least the appearance of conflict between its fiduciary responsibilities for First Nations and its obligations to act on behalf of the Crown, which has an impact on the implementation of our recommendations.

Acquisition of Leased Office Space

Public Works and Government Services Canada (PWGSC) is responsible for providing office accommodation to about 100 federal departments and agencies. The Department's real property business line has an annual business volume of about $3 billion and handles about 500 lease transactions a year. To manage this volume well, the Department needs complete, accurate, and timely information for decision making, strategic management, and risk management. Strong management practices are especially critical, given its commitment to reduce the costs of real property management by $1 billion over the next five years.

In 2002 we audited the Department's strategic planning, its risk management practices, and its analysis of options for providing office space. Our follow-up audit found that its progress since then has been unsatisfactory. There are still gaps in its financial and management information systems that pose significant risks to its $1 billion cost savings target. To achieve that target, the Department must manage its leasing projects strategically across the entire real estate portfolio. However, it will have difficulty doing that because the basic information that managers need to make critical strategic decisions does not exist, is inadequate, or is difficult to access.

The Department shares responsibility for decisions that affect the cost of office accommodation with client departments and the Treasury Board. Although it tries to identify the most cost-effective options for office space, client departments may decide on more expensive accommodations. It is difficult for PWGSC to enforce its standards for quality and quantity of office space, and this has resulted in added costs to taxpayers. In recommending the most cost-effective accommodation, the Department considers the cost of the lease over its life. However, the government's funding process focusses on annual cash spending. We found cases where the most cost-effective option could not be selected due to insufficient capital funding.

Canada Revenue Agency—Collection of Tax Debts

The vast majority of taxes and payroll deductions owed are paid on time. However, there is always a significant amount in taxes, interest, and penalties that the Canada Revenue Agency has assessed but not collected. This tax debt amounted to $18 billion at 31 March 2005. The Agency expects to collect about $13.3 billion of this amount; the rest is not likely to be collected because, for example, the taxpayer involved is insolvent. Any improvement in the Agency's ability to collect tax debts efficiently and within a reasonable length of time could add millions of dollars in revenues to the Crown every year.

We last audited this subject in 1994. In our follow-up this year, we found that the Agency had not made satisfactory progress in addressing recommendations aimed at improving the collection of tax debts. The Agency's approach to assessing files for risk continues to lack sophistication and has major weaknesses that impede the timely collection of tax debts. Further, the Agency still lacks important information needed to manage its collection of the tax debt effectively. However, it has made some significant changes to its collection systems and some of its practices, including updating the automated system that manages low-risk accounts, opening a national call centre, and establishing national pools to better manage workload. It has also improved the procedures to collect large tax debts.

Cash collected by collectors working at Tax Services Offices has increased since 1994 and now averages about $2.3 million for each collector. Yet despite this increase, the tax debt has grown at a faster rate than total taxes paid. At the same time, management is not collecting the data it needs to understand both why the amount of tax debt is growing and what it comprises.

The Agency has known for many years what it needs to do to improve the collection of tax debts but has been unable to achieve significant breakthroughs. It now has a strategic vision that sets a course for the future. The major challenge for the Agency is to turn that vision into reality through detailed planning, focussed management attention, and measurement of results.

Conclusion

Our audit work for this report generally confirms that programs and activities cannot be error-proofed by building a web of controls, rules, and regulations into their design to ward off risk. In fact, where the risks are weighed and managed, intelligent risk taking is vital to any

innovative, successful organization. Programs that are mired in controls and reporting requirements are not programs that focus most of their efforts and resources on improving the lives of Canadians. In several of the areas discussed in this report, we see a need for the government to review whether programs have too many rules and whether their administration could be streamlined to improve delivery. In many respects, the government needs fewer rules, but rules that are consistently applied.

Chapter

1

Managing Government Financial Information

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Managing Government Financial Information

Main Points

What we examined

Since 2001 we have been assessing the financial control systems and processes in federal government departments and agencies that generate financial information. For this chapter, we examined the extent to which departments have remedied weaknesses we previously identified in their internal financial controls, such as security controls in computer information systems. We looked at the extent of progress made toward implementing accrual-based budgeting and appropriations and how well departments are integrating accrual financial information into their regular decision making. We examined whether departments have strengthened their leadership in and capacity for financial management and considered what they still need to do to be ready for audits of their financial statements. In carrying out our current follow-up, we looked at 11 departments and agencies, which account for most of the government's revenues and a large part of its expenses.

Why it's important

Every year, the federal government handles billions of dollars of taxpayers' money. The 2004–05 Public Accounts of Canada reported that during the fiscal year the federal government raised $211.7 billion in revenue, spent approximately $210 billion, and held total assets of $205.9 billion and liabilities of $705.7 billion. Strong internal financial controls and complete financial information are vital if the government is to prudently manage its revenues and expenses. Effective financial controls put federal departments and agencies in a better position to manage risks and produce accurate and complete financial information for making sound decisions, exercising good stewardship over resources, and getting results for taxpayers. Gaps or weaknesses in financial controls can lead to inaccurate and unreliable financial information, poor control over physical assets, and improperly authorized financial transactions. Without good controls, an organization risks being unable to prevent or detect failures to comply with regulations, policies, and procedures.

The Government of Canada has been carrying out a government-wide project to improve the quality of financial management and internal control, an initiative that we support. An important part of this project

is improving the effectiveness of financial management practices and applying the accrual method of accounting—in addition to the cash method—to prepare financial information. Accrual accounting is a method of accounting whereby transactions and other economic events are recognized when they occur, rather than when cash or its equivalent is received or paid. This method has many advantages, the most important being that it gives managers a more complete picture of their programs' financial performance and thus offers a better tool for deciding how best to manage available resources.

What we found

- Progress in improving government financial information continues to be unsatisfactory. This is chiefly because departments and agencies make little use of accrual financial information as a regular management tool. Financial officials have indicated that departments and agencies will not use accrual financial information effectively until government-wide and departmental budgeting, financial reporting, and appropriations are done on a common basis. The Treasury Board Secretariat has been studying the issue of accrual-based budgeting and appropriations for several years.
- Departments and agencies are slowly taking action to remedy our previously reported internal financial control weaknesses. In many departments where progress has been satisfactory, the support of the deputy heads was a key factor. While the Office of the Comptroller General (OCG) is responsible for ensuring that departments and agencies employ adequate financial management and control practices, it has only recently instituted its own process to gather and evaluate information on what departments have done to respond to our earlier recommendations on financial system controls. We note, however, that the Government of Canada has made a public commitment to strengthen financial management and control, which we expect will emphasize the important role of the OCG in monitoring progress made by departments and agencies in responding to our previous recommendations.
- The departments and agencies we audited have increased the number of senior financial officials with professional designations. The Office of the Comptroller General has also continued to advance initiatives to improve departmental financial statements.

The Treasury Board Secretariat has responded. The Treasury Board Secretariat is pleased that the Office of the Auditor General has recognized the progress made to date and agrees with the direction of the recommendations in this chapter. The Secretariat's response details current or planned actions to address the recommendations made.

Introduction

The importance of sound financial information and internal controls

1.1 Every year, the federal government handles billions of dollars of taxpayers' money. The 2004–05 *Public Accounts of Canada* reported that during the fiscal year the Government of Canada had raised $211.7 billion in revenue, spent approximately $210 billion, and had assets of $205.9 billion and liabilities of $705.7 billion. Complete and reliable financial information and strong internal financial controls are central to managing the government's revenues and expenses and producing improved results for taxpayers. Establishing effective financial information systems and controls throughout the government, along with appropriate financial policies and procedures, is essential to improving the government's stewardship and leading to more informed decisions.

1.2 The Government of Canada has been carrying out a government-wide project to improve the quality of the financial information that decision makers use. An important element of this project is applying **accrual accounting**, in addition to the cash method of accounting, when preparing financial information (see Appendix A for a brief explanation of accrual accounting). Accrual financial information produces a better financial picture of the government—its resources, obligations, financing, costs, and the impacts of its activities, including the costs of consuming assets over time. This more complete picture helps legislators hold the government more accountable for safeguarding its assets, appreciate the full costs of its programs, and assess its ability to meet its short- and long-term financial obligations.

Accrual accounting—A method of accounting that records an entity's transactions and other economic events when they occur, rather than when the entity receives or pays cash or its equivalent (cash-based accounting).

1.3 Internal financial controls are also central to managing any organization effectively. An organization's financial controls contribute to the direction and culture of its financial management. To the extent that these controls are effective, an organization is better positioned to produce accurate and reliable financial information. Such information is key to developing a complete and accurate picture of an organization's financial performance.

1.4 Sound financial controls are also essential to helping an organization manage the risks it is exposed to. When these controls work properly, they increase the decision makers' assurance that financial information is reliable enough to support well-informed decisions. They also reduce the possibility of fraud and error in financial information, and they help to ensure that all transactions are properly

authorized and comply with applicable policies, procedures, laws, and regulations. Any weaknesses in financial control will increase risk.

1.5 **The government recognizes the need to strengthen financial information and internal control.** With the government's 12 December 2003 reorganization plan, the Treasury Board of Canada Secretariat focussed on strengthening and supporting comptrollership and financial management in government. Specifically, the Secretariat is now responsible for ensuring that departments and agencies meet all the government's financial planning and control requirements and for overseeing their expenditures.

1.6 In 2003, the Treasury Board Secretariat also reinstated the Office of the Comptroller General (OCG) as a distinct unit within the Secretariat. The main priorities of the OCG include restoring public confidence in the government's financial management practices, improving the quality and credibility of financial information, and strengthening the role of internal audit **(see Priorities of the Office of the Comptroller General, page 21).**

1.7 In our view, as the government responds to these priorities, departments and agencies will need to have strong financial information and internal controls. This will ensure that they are relying on accurate financial information and that they meet the expectations identified by the government as critical in restoring public confidence in its financial management practices.

Focus of the audit

1.8 The chapter is a follow-up to our 2005 Status Report, Chapter 8, and other reports arising from our past audits of the government's summary financial statements. We evaluated the progress that departments and agencies have made in addressing the weaknesses we identified in our assessments of key financial controls governing selected computer information systems used for financial reporting. We also reviewed the progress and impact of various issues that we discussed in our previous work, including the following:

- advancements in implementing accrual-based budgeting and appropriations at the departmental level;
- weaknesses in central and departmental leadership and capacity;
- the integration of accrual financial information into internal reports and into the information that decision makers use; and
- the readiness of departments for audit of their departmental financial statements.

Priorities of the Office of the Comptroller General

The priorities of the Office of the Comptroller General are to strengthen the financial information and internal control framework across the federal public service by

- nurturing and developing the financial and internal audit communities;
- establishing a new financial management regime and a management control framework and updating financial management policies;
- developing certification standards and a core learning strategy for financial management and internal audit;
- setting and reviewing financial, accounting, and auditing standards and policies for the Government of Canada;
- developing a revised internal audit policy;
- developing governance and protocols for internal audit services to smaller departments and for government-wide audits;
- establishing the capacity to perform quality assessments of internal audit functions;
- leading the introduction of modern, timely, enterprise-wide financial information systems and developing associated business processes and standards;
- overseeing government spending, including policies, processes, and criteria for review and sign-off of spending proposals, and monitoring and reporting provisions; and
- providing guidance for preparing departmental financial statements and the Public Accounts of Canada.

Source: Adapted from Treasury Board Secretariat and Office of the Comptroller General documents

1.9 Further details on the audit objective, scope, approach, and criteria are included in **About the Audit** at the end of the chapter.

Observations and Recommendations

Using accrual financial information

The unresolved issue of accrual budgeting and appropriations is limiting the use of accrual financial information

1.10 Our previous chapters have highlighted a lack of progress with respect to full accrual-based budgeting and appropriations, and the impact this has had on departments' and agencies' use of accrual financial information in decision making. The House of Commons Standing Committee on Public Accounts continues to support our recommendations on accrual-based budgeting and appropriations and has repeatedly urged the Treasury Board Secretariat to act on this issue (see Appendix B).

1.11 In our 2005 Status Report, Chapter 8, we noted that departments were not using accrual financial information in their day-to-day operations. Instead, they were using the accrual method only to prepare information for the government's year-end summary financial statements and to address the requirement to include such information in Treasury Board Secretariat submissions and memoranda to Cabinet.

1.12 A department's annual cash requirements and management of cash flows will continue to be important information for Parliament. It is our opinion, however, that Parliament will be better served if it also receives budget information that is based on accrual accounting and reflects the full costs of programs as part of the estimates and appropriations process and all other forms of financial reporting. This approach would ensure that the information Parliament receives and that managers use in their decision making would be comparable with the accrual information included in the *Public Accounts of Canada* and the government-wide budget.

1.13 In this follow-up audit, we continued to find that most departments still do not use accrual financial information for managing on a day-to-day basis or making most financial decisions. Senior financial officials told us that managers have no incentive to use accrual financial information to manage their department's resources because their budgets and appropriations are based on the cash method of accounting. As a result, with a few exceptions, financial information used in decision making continues to rely on a method of accounting that, in our opinion, provides a less complete and accurate financial picture.

1.14 Furthermore, this issue does not seem to be among the Treasury Board Secretariat's priorities related to strengthening financial information. The Secretariat has been studying departmental accrual-based budgeting and appropriations for many years, but it has not yet completed this work. Following a request of the Public Accounts Committee, we expected the Secretariat to have developed and begun implementing an appropriate action plan for resolving the matter of full accrual-based budgeting and appropriations.

1.15 While Treasury Board Secretariat officials have not yet concluded their research, they have made some progress since our last audit. For example, they have consulted with departments and agencies on implementation strategies. They have also explored the impact of implementing accrual-based budgeting and appropriations

for capital assets and for updating annual spending levels. In addition, they recently hired an independent consultant to survey the practices of other governments.

1.16 Departments are also trying to include and use accrual financial information in limited situations. For example, departments record monthly payroll on an accrual basis, but only some departments incorporate this information into their monthly management reports. Other departments have incorporated accrual financial information into selected decisions.

1.17 We acknowledge the importance of cash-based information for departments and agencies and that the issue of using accrual-based budgeting and appropriations requires careful consideration. However, the Treasury Board Secretariat needs to complete its study on accrual-based budgeting and appropriations in order to advance the government's use of accrual financial information. Paragraphs 7.24 and 7.25 of Chapter 7 of this report provide an excellent example of the limitations now imposed on decision making by the current method of departmental budgeting and appropriations.

1.18 Recommendation. The Treasury Board Secretariat should promptly complete the study of accrual-based budgeting and appropriations at the departmental level. It should then present the proposed approach for a common basis of planning, budgeting, and reporting, along with an implementation plan, to the House of Commons Standing Committee on Public Accounts.

The Treasury Board Secretariat's response. As mentioned in the chapter, the Treasury Board Secretariat has engaged an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government. The study will provide information on issues such as practices in other jurisdictions and the rationale for adoption/rejection of accrual concepts in other jurisdictions; treatment of non-cash expenses and other differences between cash and accrual accounting; cultural and behavioural changes; the readiness of departments to implement any changes; and possible options and phasing for proceeding.

The Secretariat agrees with the recommendation and will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of

implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The Secretariat also agrees that the government will develop an appropriate implementation plan and will share this information with the Public Accounts Committee, other parliamentarians, and other competent bodies, such as the House of Commons Finance Committee.

The implementation of accrual accounting for reporting, budgeting, or appropriations has been an issue before national jurisdictions for well over a decade. Over the years, some jurisdictions made significant efforts implementing accrual accounting for financial reporting. The federal budget and the summary financial statements of the Government of Canada are now prepared on a full accrual basis, helping make Canada "a world leader in financial reporting by a national government," according to the Auditor General. However, relatively few countries have yet extended accrual accounting to budgeting or appropriations. Canada is not alone in taking a cautious and prudent approach. The study now under way will provide the information that the Secretariat will need to determine the appropriate approach to be taken to accrual budgeting and appropriations.

Responding to identified financial control weaknesses

Progress has been slow in responding to key weaknesses in internal financial controls

1.19 We have been assessing selected internal financial controls in various departments and agencies since 2001. Specifically, our focus has been on financial controls related to certain **computer information system controls**, associated **management and monitoring controls**, and **processing controls**. Our objective has been to determine the extent to which these controls contributed to the safeguarding of assets and to the accuracy, completeness, and proper authorization of financial information used to produce the government's summary financial statements.

Computer information system controls—Security controls that are primarily preventive. They manage the access and use of financial information within various computer applications.

Management and monitoring controls—Ongoing oversight procedures or periodic evaluations that managers perform. They are useful in detecting errors, and they ensure that business processes or other controls are operating as expected.

Processing controls—Processes or practices that are useful in preventing and detecting errors and typically operate at a detailed business process (transactional) level. They are designed to ensure the integrity of financial records.

1.20 In 2004, we began to reassess the progress of departments and agencies in dealing with the internal financial control weaknesses that we had been reporting since 2001. We first reported on the results of our follow-up in our 2005 Status Report, Chapter 8. We noted that certain departments and agencies had dealt with some of our concerns about their internal financial controls, but other weaknesses remained. When we first identified these weaknesses, we noted that, in our opinion, departments and agencies could resolve most of them within a

reasonable period. Therefore, in our 2005 Report, we indicated that we expected departments and agencies to have made more progress in this direction.

1.21 In this follow-up audit, we looked at 11 departments and agencies (see About the Audit). Our objective was to determine the extent to which each organization had dealt with the internal financial control weaknesses that we had noted in 2001, 2002, or 2003. These 11 departments and agencies account for most of the government's revenues and incur a large part of its expenses.

1.22 Our ratings reflect only the progress that each department or agency has made in addressing weaknesses we previously identified. The ratings do not compare one department with another or evaluate the quality of their entire internal financial control systems. The scope of our assessments was not large enough to identify all internal control matters that might be of interest to the government. In addition, we are aware that in evaluating the extent of progress achieved, the control weaknesses identified for each entity differ in quantity, type, and complexity, and these differences in turn influence the level of progress achieved.

1.23 Some departments and agencies have satisfactorily addressed previously identified internal financial control weaknesses in their financial application systems that we reported on in 2001, 2002, or 2003 (Exhibit 1.1).

Exhibit 1.1 Departments and agencies that have satisfactorily addressed internal financial control weaknesses we previously identified

Departments and agencies	Financial application systems that report incurred expenses
Agriculture and Agri-Food Canada	SAP
Canadian Heritage Canada	SAP
	GCIMS
Veterans Affairs Canada	FreeBalance
	Client Service Delivery Network (CSDN)
Industry Canada	SAP
Public Works and Government Services Canada	Common Departmental Financial System (CDFS)

1.24 In addition, as part of our financial audit of the public accounts submissions, we assessed the progress of Agriculture and Agri-Food Canada, Canadian Heritage, Foreign Affairs and International Trade, Health Canada, and Industry Canada in addressing previously identified internal financial control weaknesses that were not part of the financial application systems. We found that these departments had made satisfactory progress in addressing these weaknesses.

1.25 Other departments and agencies have not yet satisfactorily addressed all previously identified weaknesses in their financial application systems. They have taken measures to remedy some of the weaknesses that we previously identified, but additional actions are required to satisfactorily address all remaining weaknesses (Exhibit 1.2).

Exhibit 1.2 Departments and agencies that have not yet satisfactorily addressed all internal financial control weaknesses we previously identified

Department or agency	Financial application systems that report incurred expenses
Indian and Northern Affairs Canada	Oracle
	TPMS
Transport Canada	Oracle
Canada Revenue Agency	SAP-CAS expenditure system

Department or agency	Financial application systems that report revenues
Canada Revenue Agency	SAP–revenue ledger (pre-implementation controls review)
	T1 assessment/accounting
	T2 assessment/accounting
	T4 assessment/accounting

1.26 As part of our financial audit of public accounts submissions, we also assessed the progress of Public Works and Government Services Canada, Veterans Affairs Canada, and Indian and Northern Affairs Canada in addressing previously identified internal financial control weaknesses not part of the financial application systems. While these departments have also made progress in addressing these weaknesses, they need to take further action to satisfactorily address all the reported weaknesses.

1.27 Control weaknesses have not resulted in material errors. Despite the unresolved weaknesses in internal financial controls, we did not find any material errors in the information that departments and agencies provided to prepare the Government of Canada's 2004–05 summary financial statements. Nevertheless, as we noted earlier, any weakness in financial controls entails risk and may result in incomplete or inaccurate financial information in the future.

1.28 Factors contributing to success. For most departments and agencies, our original assessments identified weaknesses in systems that were new at the time. Where progress has been made in addressing weaknesses, we found that deputy heads strongly supported any projects intended to eliminate these weaknesses and, accordingly, senior managers had assigned a high priority to these projects. In addition, internal auditors worked with financial, information technology, and program staff to solve any problems we had identified, and they provided assurance to senior managers on the reliability of the financial information these systems produced.

1.29 Although departments and agencies may have corrected many of the previously identified weaknesses, and material errors may not have resulted, they need to continue to look for ways to improve their systems and practices and ensure that their financial information systems provide complete, accurate, and reliable information to make informed decisions. It is important that they continue building on their successes to date.

1.30 Factors contributing to slow progress. We expected to see more progress in addressing control weaknesses. Some departments cited reorganization as a factor that had resulted in competing priorities. Staff members who were responsible for maintaining financial systems had spent time on reorganization duties and on various other initiatives, such as expenditure and program reviews.

1.31 When we discussed these factors with the Canada Revenue Agency and other departments where we found that all previously identified weaknesses had not yet been satisfactorily addressed, officials informed us that addressing the weaknesses is a priority and that senior management agrees that solutions to these weaknesses must be implemented. To that end, the departments and agencies identified in Exhibit 1.2 are continuing to make progress in their efforts to respond to our previously identified internal financial control weaknesses.

1.32 In particular, the Canada Revenue Agency's progress on certain systems was slow, partly because the Agency operates more systems than other departments, as well as larger and more complex systems. Finally, while the government has moved toward reporting financial information on an accrual basis, the Agency's systems for reporting revenues were not designed to produce information on this basis, and considerable effort has been needed to remedy this situation.

1.33 **We were unable to assess some departments' progress.** Three departments—Health Canada, Foreign Affairs Canada, and Citizenship and Immigration Canada—were upgrading their financial application systems during our follow-up work in 2005. Because they agreed to consider the identified internal financial control weaknesses when they upgrade their systems, we decided to follow up and re-evaluate these systems later to determine if they have addressed the weaknesses.

The role of the Office of the Comptroller General in monitoring internal financial control weaknesses is increasing

1.34 The Government of Canada, with the Office of the Comptroller General (OCG) as lead, is responsible for ensuring that all departments and agencies establish good financial management practices and systems of internal financial control. However, the OCG has been concentrating on many of its other responsibilities, particularly the development of a new internal audit policy and a framework to strengthen the capacity of the government's financial community. Thus, it has been slow to fulfill its responsibility for identifying internal financial control weaknesses. Only recently has the OCG instituted its own process to evaluate what departments have done, in response to our earlier recommendations, to improve their internal financial controls.

1.35 However, some of the recent initiatives of the Office of the Comptroller General play a key role in reinforcing the importance of financial information and financial controls in departments and agencies. For example, the OCG is leading the Government of Canada initiative to create the position of Chief Financial Officer (CFO) in each department and agency. The CFO will oversee the financial management, control, and reporting functions of a department or agency. The OCG is proposing that this position also include overseeing, managing, and maintaining strong internal financial control systems. It has also agreed to reorganize and bolster the internal audit function to give auditors responsibility for assessing and reporting on the quality of internal financial control systems.

1.36 Additional detailed guidance about the role of the CFO and about internal audit's expanded focus on internal financial controls would strengthen the importance of financial controls in departments and agencies and demonstrate the OCG's commitment to this issue. Finally, as the Office of the Comptroller General seeks accounting support from the private sector to assess the ability of departments to prepare audited financial statements, it could also use this expertise to assess internal financial control systems.

1.37 Recommendation. The Office of the Comptroller General should

- work closely with internal auditors and senior financial officials in departments and agencies to develop a strategy for strengthening internal financial controls,
- develop an implementation plan that includes deadlines by which departments and agencies must identify and remedy any weaknesses in their internal financial control systems and that provides for assessing and monitoring the progress in addressing those weaknesses, and
- regularly monitor the actions of departments and agencies to assess their progress against this plan.

The Treasury Board Secretariat's response. The Treasury Board Secretariat agrees with the direction of the recommendations and acknowledges the importance of continuing to strengthen internal financial controls. To this end, the Secretariat has commenced initiatives to improve and strengthen the policy environment surrounding internal financial controls. The new internal audit policy requires that departmental deputy heads approve the department's internal audit plan. The audit plan should address audits identified by the Office of the Comptroller General (OCG), including audits that address fundamental controls. The audit plan should also support an annual opinion from the Chief Audit Executive on departmental risk management, control, and governance processes. The OCG has already started working with departmental chief audit executives and with senior financial officers to develop the process required to support the identification of key financial controls requiring audit coverage, as outlined in the new policy.

As mentioned in the chapter, the OCG regularly reviews internal audit reports and management letters in order to monitor and help remedy control weaknesses in departments and agencies.

In addition, the initiative to audit departmental financial statements will significantly affect and improve the financial control environment in departments. In preparation for the audit of their departmental financial statements, each department must ensure that its processes are well documented and exist within a sound internal control environment. While this initiative initially focusses on large departments, as part of its preparation, each department must undergo an audit readiness assessment by an external auditing firm, which will include an assessment of the control environment. The OCG will monitor the results of these assessments and will work with departments to ensure that corrective action is taken as required. The Treasury Board Secretariat is confident that, through these initiatives, we will continue to achieve progress in improving internal financial controls.

Improving financial management practices

Financial capacity is increasing in strength

1.38 In February 2005, we noted that the departments and agencies we examined had made some progress in increasing the number of senior financial staff with professional designations. In our current audit, we updated our 2002 statistics for 11 of the larger departments and agencies we had been monitoring. We found that 16 of 22 senior financial officers and senior full-time financial officers now have a professional accounting designation, up from the 8 of 22 that we reported in December 2002. The attention of departments and agencies and of the Office of the Comptroller General to this matter has clearly produced positive results and indicates what can happen if the government treats an issue as a priority.

1.39 During our last audit, we also noted that the Government of Canada, with the Office of the Comptroller General as lead, had not yet clarified what steps departments and agencies needed to take to implement the position of Chief Financial Officer. By August 2005, two departments we had examined in our 2002 audit had taken steps to initiate or adapt the structure of their financial function to accommodate a CFO. The remaining nine departments told us they were awaiting more guidance from the OCG.

1.40 Within the Office of the Comptroller General, there is now an Assistant Comptroller General who is responsible for capacity building, community development, and developing the model for the CFO position within departments, in accordance with the plans and priorities established by the OCG. Next steps will now be to develop, implement, and monitor government-wide requirements for

professional certification and to build capacity in financial management. Such actions will allow the government to further strengthen its financial management capacity and enhance the role of the Chief Financial Officer.

Progress in improving departmental financial statements continues

1.41 The Office of the Comptroller General has recently developed a schedule to start assessing, beginning in 2005–06, the extent to which most large government departments are ready to have their financial statements audited. External auditors and internal departmental auditors will carry out these assessments. OCG officials are now developing guidance for departments to start preparing for these assessments and have updated other guidance on how to prepare departmental financial statements. Although additional actions are still required, the other guidance has substantively advanced the outstanding issues related to preparing departmental financial statements that we highlighted in our 2005 Status Report.

1.42 We noted that some departments have taken initiatives to improve the process for preparing financial statements. One department has employed external consultants to review and assess its financial statements. Another is pursuing the possibility of producing its monthly financial statements on an accrual basis, instead of merely at year-end.

1.43 As reported in previous chapters, however, departments normally prepare their financial statements only once a year, for the purpose of reporting to the Office of the Comptroller General. In most cases, officials prepare these statements after year-end and after they have gathered information for public accounts. As in previous audits, we found no evidence that these financial statements are used for regular decision making in departments or that senior management committees review them.

Assessing progress in improving financial information

1.44 Since 2002, we have been calling attention to various weaknesses in the government's internal financial control systems and its preparation and use of financial information. However, progress in dealing with these weaknesses has been slow and uneven.

1.45 In assessing the government's progress in responding to our previous recommendations on improving financial information, we have provided a rating of our level of satisfaction (Exhibit 1.3).

Exhibit 1.3 **Progress in addressing recommendations on improving financial information**

Recommendation	Progress
The Treasury Board of Canada Secretariat should promptly complete its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common accrual basis of planning, budgeting, and reporting. (February 2005 Status Report, Chapter 8, paragraph 8.43, also consistent with March 2004 Report, Chapter 6, paragraph 6.58)	○
The Office of the Comptroller General, in conjunction with department and agency deputy ministers, should ensure that departments and agencies have strategies, where applicable, for improving the quality and use of accrual financial information that supports their regular financial reporting, analysis, and decision-making process. (February 2005 Status Report, Chapter 8, paragraph 8.56, also consistent with March 2004 Report, Chapter 6, paragraph 6.81)	○
The Office of the Comptroller General, in co-operation with departmental and agency management, internal audit groups, and audit committees, should ensure that departments and agencies identify and address the internal control weaknesses in financial information systems within a reasonable period. (February 2005 Status Report, Chapter 8, paragraph 8.37, also consistent with March 2004 Report, Chapter 6, paragraph 6.92)	○
The Comptroller General, in conjunction with senior financial officials in departments and agencies, should develop a vision, strategy, and implementation plan with key milestones for promoting and improving the financial capacity in departments and agencies that are consistent with the government's announced support in this area. (February 2005 Status Report, Chapter 8, paragraph 8.25, also consistent with March 2004 Report, Chapter 6, paragraph 6.51)	●
The Office of the Comptroller General should promptly resolve any outstanding issues regarding departmental financial statements and develop a plan to achieve the commitment of having audited financial statements within five years. (February 2005 Status Report, Chapter 8, paragraph 8.63, also consistent with March 2004 Report, Chapter 6, paragraph 6.98)	●

● **Satisfactory** — Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory** — Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Conclusion

1.46 Departments and agencies need to continue to improve their internal financial controls. In our view, until the government has addressed our concerns about internal financial control, the quality of financial information that departments and agencies use for many of their key decisions will be at risk.

1.47 We are also concerned that, with a few exceptions, most financial information for use in decision making continues to be primarily based on the cash method of accounting. This information provides a less complete and less accurate picture of a department's or agency's financial situation than does information prepared by the accrual method.

1.48 Although departments and agencies have increased the number of senior financial officials with professional designations, and the Office of the Comptroller General has continued to advance initiatives to improve departmental financial statements, the use of accrual financial information as a regular management tool needs to be increased. Currently, accrual financial information is mainly used as part of a year-end exercise to comply with requirements for preparing the government's summary financial statements.

1.49 Finally, and most important, the government still has not resolved the issue of accrual-based budgeting and appropriations at the departmental level. Although we acknowledge that the government needs to consider this issue carefully, the Treasury Board Secretariat has been studying it for many years and has not yet resolved the issue. We continue to believe that the government must adopt a common basis for budgeting, appropriations, and financial reporting at the departmental level. Only then will it be able to improve the use of accrual financial information.

About the Audit

Objective

The objective of this audit was to assess the extent to which departments and agencies have addressed the key internal financial control weaknesses we identified in our 2001, 2002, and 2003 control assessments. We conducted those assessments as part of our audit of the federal government's summary financial statements. The objective of that audit is to report on the fairness of the presentation of the summary financial statements.

We also examined other elements of previous chapters, particularly the progress on the issue of accrual-based budgeting and appropriations to determine the progress the government had achieved in each area.

Scope

The scope of the audit included the following departments: Canadian Heritage, Agriculture and Agri-Food Canada, Veterans Affairs Canada, Public Works and Government Services Canada, Foreign Affairs Canada/International Trade Canada, Indian and Northern Affairs Canada, Transport Canada, Citizenship and Immigration Canada, Industry Canada, and Health Canada.

In addition, our audit scope included the Treasury Board Secretariat, because it is responsible for government-wide financial accounting, management, and control issues. We also included the Canada Revenue Agency in our scope, but only relative to the follow-up on any previous assessments of the financial application systems.

Approach

We audited the summary financial statements in accordance with Canadian generally accepted auditing standards, and we assessed whether the statements were fairly presented in accordance with the government's stated accounting polices.

Our audit procedures included testing transactions and account balances, performing analyses, confirming year-end balances with third parties, reviewing significant internal controls, and discussing significant matters with government officials.

As a result, this follow-up relies on the nature, scope, and extent of our audit of the summary financial statements. It contains some of our observations and findings from this earlier audit work and from other audits the Office of the Auditor General conducted in the area of financial management and control.

Additional work included interviews with senior officials and a review of documents containing accrual financial information that managers used to support their financial decisions.

Criteria

The criteria we used are based on the actions we expected the government to take in response to our recommendations in our March 2004 Report, Chapter 6, and February 2005 Status Report, Chapter 8, and

on the government's announcements in its 12 December 2003 reorganization plan and its 2004 Budget (commitments to strengthen financial management and control).

We expected that

- departments and agencies would have improved their internal financial control systems and addressed all the significant weaknesses we had identified, and that they would have begun integrating accrual financial information into their regular decision-making processes;
- departments and agencies would have increased their professional accounting capacity and developed appropriate plans to implement the Chief Financial Officer's new oversight responsibilities;
- the Treasury Board Secretariat would have actively overseen and monitored the actions that departments took to improve their financial control systems, professional accounting capacity, use of accrual financial information, and preparation of financial statements;
- the Secretariat would have concluded its study of accrual-based budgeting and appropriations and would have developed an implementation plan; and
- the Secretariat would have finished developing the remaining accrual accounting policies and practices for departments and agencies, which would result in departmental financial statements that are ready for audit.

Audit work completed

Audit work for this chapter was substantially completed on 14 October 2005.

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Appendix A The accrual method of accounting

What is accrual accounting? Accrual accounting refers to a method of accounting that records an entity's financial transactions and other economic events when they occur, rather than when the entity receives or pays cash or its equivalent. It records expenses as goods or services are consumed, and it records revenues in the period to which they pertain. It recognizes the life-cycle costs associated with long-lived assets.

An example. Assume that in 2005, a department purchases a fleet of trucks for $1.2 million. The trucks have a useful service life of six years. Under the cash method, government accounts would record the trucks in 2005 as a one-time expenditure of $1.2 million. However, under the accrual method, the accounts would record the same purchase much differently. Because the trucks have an expected service life of six years, the purchase would appear as follows in the 2005 accounts:

- Expense in 2005: $200,000, or one sixth of $1.2 million—the expected use per year
- Assets (trucks): $1 million ($1.2 million purchase price less the $200,000 expense for the use of the assets)

Accrual information clearly presents a very different—but more accurate—picture of the organization's financial results for 2005. On the basis of this information, managers become aware of the cost of owning the fleet over time. They can focus on the stewardship of assets, because the assets are now clearly and transparently recorded in the department's financial accounts. For example, the $200,000 will be an expense recorded every year for the life of the trucks, and the trucks will also continue to be reflected as assets until they are fully consumed or sold. Thus, managers can see the need to consider the costs of maintaining, disposing, and replacing assets. When these costs are visible, managers are also more likely to consider risks, such as loss due to damage or theft.

Benefits. Accrual accounting records the estimated costs and liabilities associated with events, such as an environmental event or accident, when they occur. For example, if a serious chemical spill occurred on government property, the government would record in the accounts the estimated cost of cleaning it up, along with other potential financial liabilities, when the accident happened, not when the bills were paid in the future. Because the costs and future liabilities are recognized and recorded, managers are more likely to be concerned about how to manage them.

In essence, accrual accounting improves government decision making because what "gets recorded, gets managed." When all the costs are visible, managers are more likely to consider those costs when making decisions.

Appendix B House of Commons Standing Committee on Public Accounts: Recommendations on accrual-based budgeting and appropriations and the government's response

Report	Recommendation	Response
December 1998	The Treasury Board Secretariat should complete its consultations with its stakeholders as quickly as possible in order to determine the best possible options to move the appropriations (supply) process to a full accrual basis.	Progress is slower than anticipated. Response to a consultation paper is expected by 10 March 2000, from which recommendations to the government will be made in the following two or three months.
March 2000	The Treasury Board Secretariat should complete its consultations with departments and agencies on moving to accrual appropriations. Once the consultations are completed, the Treasury Board Secretariat should inform Parliament and the Public Accounts Committee in writing of its final decision and recommendations to the government on moving to accrual appropriations.	Responses to the consultation paper have been received and are being compiled and analyzed. Completion of the analysis is expected by September 2000, although further review of accrual-based budgeting and its relationship with appropriations may be required.
March 2001	The Treasury Board Secretariat should complete its consultations with parliamentarians aimed at determining the best possible options to convert the appropriations (supply) process to a full accrual basis and report the results to the House of Commons by 31 March 2002; the Government of Canada should move to an accrual-based system of appropriations (supply) by 1 April 2003.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. Any decision made will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
May 2001	The Treasury Board Secretariat should undertake and complete the required studies and consultations on full accrual-based appropriations, and it should prepare a set of proposals and alternatives to be presented to the House of Commons Standing Committee on Public Accounts, no later than 31 March 2002.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. The decisions made respecting any contemplated changes to our budgeting and appropriations practices will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
December 2002	The government should adopt the integration of full accrual-based budgeting and appropriations into the Canadian Expenditure Management System and advise the Public Accounts Committee when the decision has been made. Once the decision is made to move toward full accrual-based budgeting and appropriations, the Treasury Board Secretariat should immediately prepare an action plan together with an implementation timeframe and table both these documents with the Public Accounts Committee.	Adopting the integration of full accrual-based budgeting and appropriations into the Expenditure Management System could have far-reaching implications for government and for Parliament. Unlike accrual accounting, there is no international consensus on the adoption of accrual budgeting. Those countries that have implemented accrual budgeting have adopted specific accrual tools to suit their specific need and to help them implement much broader reforms. Moreover, some countries have indicated that their accrual budgeting frameworks are not yet proven and may be subject to change in the context of lessons learned. We intend to learn from their experience.

Report	Recommendation	Response
February 2005	The government should extend full accrual accounting to budgeting and appropriations and set a firm timeline for its completion. The Public Accounts Committee further recommends that the government report back to Parliament annually on the progress being made in this respect.	Since the impacts of adopting accrual-based budgeting and appropriations are major and far-reaching, the Treasury Board Secretariat continues to believe that a prudent and thorough approach to introducing changes in budgeting or appropriations is the most appropriate approach. Although the rate of change is slower than the Standing Committee on Public Accounts or Auditor General would like, progress is being made in the area of accrual-based budgeting. As announced in Budget 2005, the government will be implementing a more rigorous approach to capital planning, beginning with a few pilot departments this fall. Parliament will be asked to consider multi-year appropriations of capital funds for these pilot departments. The Treasury Board Secretariat is also examining the feasibility of conducting the annual reference level update exercise on an accrual basis, as well as the cash basis on which it is presently based. The Treasury Board Secretariat will report back to Parliament annually, through its departmental performance report.

Source: Adapted from reports of the House of Commons Standing Committee on Public Accounts

Appendix C List of recommendations

The following is a list of recommendations found in Chapter 1. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
Using accrual financial information	
1.18 The Treasury Board Secretariat should promptly complete the study of accrual-based budgeting and appropriations at the departmental level. It should then present the proposed approach for a common basis of planning, budgeting, and reporting, along with an implementation plan, to the House of Commons Standing Committee on Public Accounts. (1.10–1.17)	As mentioned in the chapter, the Treasury Board Secretariat has engaged an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government. The study will provide information on issues such as practices in other jurisdictions and the rationale for adoption/rejection of accrual concepts in other jurisdictions; treatment of non-cash expenses and other differences between cash and accrual accounting; cultural and behavioural changes; the readiness of departments to implement any changes; and possible options and phasing for proceeding. The Secretariat agrees with the recommendation and will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The Secretariat also agrees that the government will develop an appropriate implementation plan and will share this information with the Public Accounts Committee, other parliamentarians, and other competent bodies, such as the House of Commons Finance Committee. The implementation of accrual accounting for reporting, budgeting, or appropriations has been an issue before national jurisdictions for well over a decade. Over the years, some jurisdictions made significant efforts implementing accrual accounting for financial reporting. The federal budget and the summary financial statements of the Government of Canada are now prepared on a full accrual basis, helping make Canada "a world leader in financial reporting by a national government," according to the Auditor General. However, relatively few

Recommendation	Department's response
	countries have yet extended accrual accounting to budgeting or countries have yet extended accrual accounting to budgeting or appropriations. Canada is not alone in taking a cautious and prudent approach. The study now under way will provide the information that the Secretariat will need to determine the appropriate approach to be taken to accrual budgeting and appropriations.
Responding to identified financial control weaknesses	
1.37 The Office of the Comptroller General should • work closely with internal auditors and senior financial officials in departments and agencies to develop a strategy for strengthening internal financial controls, • develop an implementation plan that includes deadlines by which departments and agencies must identify and remedy any weaknesses in their internal financial control systems and that provides for assessing and monitoring the progress in addressing those weaknesses, and • regularly monitor the actions of departments and agencies to assess their progress against this plan. **(1.19–1.36)**	The Treasury Board Secretariat agrees with the direction of the recommendations and acknowledges the importance of continuing to strengthen internal financial controls. To this end, the Secretariat has commenced initiatives to improve and strengthen the policy environment surrounding internal financial controls. The new internal audit policy requires that departmental deputy heads approve the department's internal audit plan. The audit plan should address audits identified by the Office of the Comptroller General (OCG), including audits that address fundamental controls. The audit plan should also support an annual opinion from the Chief Audit Executive on departmental risk management, control, and governance processes. The OCG has already started working with departmental chief audit executives and with senior financial officers to develop the process required to support the identification of key financial controls requiring audit coverage, as outlined in the new policy. As mentioned in the chapter, the OCG regularly reviews internal audit reports and management letters in order to monitor and help remedy control weaknesses in departments and agencies. In addition, the initiative to audit departmental financial statements will significantly affect and improve the financial control environment in departments. In preparation for the audit of their departmental financial statements, each department must ensure that its processes are well documented and exist within a sound internal control environment. While this initiative initially focusses on large departments, as part of its preparation, each department must undergo an audit readiness assessment by an external auditing firm, which will include an assessment of the control environment. The OCG will monitor the results of these assessments and will work with

Recommendation	Department's response
	departments to ensure that corrective action is taken as required. The Treasury Board Secretariat is confident that, through these initiatives, we will continue to achieve progress in improving internal financial controls.

Chapter

2

National Defence

Military Recruiting and Retention

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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National Defence
Military Recruiting and Retention

Main Points

What we examined

We examined whether National Defence has made progress in addressing its recruiting and retention problems since our last audit in 2002. At that time, we found that the Canadian Forces needed to fill shortages in many military occupations and were having problems recruiting enough people to meet operational demands. They also had problems addressing the issues that were causing people to leave the military, especially in some key occupations. This time we examined the measures that National Defence has put in place since 2002 to manage Regular Force recruiting and retention. We looked at whether measures are consistent with operational requirements and the Canadian Forces' transformation goals.

Why it's important

National Defence and the Canadian Forces plan to generate and retain a trained, combat-capable, multi-purpose force that can support a wide range of military operational duties. To achieve this, National Defence needs to have the required number of trained and effective personnel in its military occupations. Shortages in personnel have contributed to an operational pause—meaning that the Canadian Forces have had to pull back on some commitments. The military is embarking on a major transformation that includes, in part, an increase of 5,000 personnel over the next five years. It has identified this expansion as a priority if it is to meet operational demands.

What we found

- National Defence has made satisfactory progress overall since 2002 in responding to our recommendations. It has improved at recruiting and retaining the numbers of people needed in its military occupations. By 2005 it had stopped the decline in the number of people trained and available for duty (its trained effective strength), but has been able to increase that number by only about 700, despite having recruited about 20,000 new members into the Regular Force since our last audit.
- The recruiting and attrition problems that remain are jeopardizing the success of the Canadian Forces' planned expansion. Faced with a changing Canadian demographic profile, a low interest among Canadian youth in joining the military, and increasing military

operational demands, the current recruiting system is not supporting the needs of the Canadian Forces. Further, National Defence forecasts an increase in attrition over the next 10 years. Because the Department has not measured the impacts or tracked the progress of the retention strategy it developed in 2001, it cannot demonstrate that the strategy has helped to increase the trained effective strength or resolve shortages in key military occupations.

- In the past, effective management of military human resources has been hindered by a lack of clarity about the authority and responsibilities of the Assistant Deputy Minister-Military Human Resources. In November 2005, National Defence endorsed new terms of reference for the position, clarifying the responsibilities and recognizing this position as the single authority to manage the Canadian Forces personnel system. National Defence has begun to take military human resources management into account in its long-term strategic planning for the Canadian Forces. However, policies, systems, and practices have yet to reflect the new strategic direction of the Canadian Forces.

The Department has responded. The Department of National Defence has agreed with our recommendations. Its detailed response follows each recommendation throughout the chapter.

Introduction

2.1 In our April 2002 Report, we reported on the recruitment and retention of military personnel by National Defence. At that time, we found that the Department understood its problems with military human resources but needed stronger management and better information to help it address the challenges it faced. The Department has responded to the recommendations we made in 2002.

Key findings in 2002

2.2 We recommended that National Defence consider developing a military (non-civilian) occupation for positions related to human resources management. In 2002, the Department began an occupational analysis of the senior human resources management positions—those that deal with issues at a strategic level. This analysis aimed at identifying the tasks, skills, knowledge, and training necessary for senior human resources managers to perform effectively. The analysis has been postponed until it can be better aligned with the new Canadian Forces strategic direction issued in April 2005. When the analysis is completed, National Defence will examine possible options for military human resources management.

2.3 In 2002 we reported on shortages of personnel in the middle ranks of the military. To alleviate the problem, National Defence needed to consider options for introducing people into these ranks. The Department is in the process of examining the possibility of bringing some recruits who have the required occupational skills into ranks above the entry level. It is now assessing the viability of this approach as it conducts its Military Occupational Structure Analysis Redesign and Tailoring Project.

2.4 National Defence recognized in 2002 the need for better performance measures and accurate, consistent data for decision making. We found that the Department has gathered more data on human resources management; however we noted inconsistencies from one data system to another. The Department has also done some basic work on performance measures for human resources management, but it recognizes the need to continue to improve in these two areas (Exhibit 2.1).

2.5 Since 2000, National Defence has conducted several studies to improve its human-resources management systems, policies, and practices in order to recover from past personnel reductions and improve efficiency and effectiveness.

Exhibit 2.1 Progress on addressing our recommendations on recruitment and retention of military personnel

Recommendation	Progress
Auditor General's April 2002 Report, Chapter 5	
The Canadian Forces should consider adopting a human-resource management occupation to ensure that it maintains the experience and expertise it needs to identify issues, develop policy, and implement changes over the long term (paragraph 5.83).	●
As it reviews the terms of service and the military occupation structure, the Department should consider all options, including recruiting experienced people into its higher ranks (paragraph 5.86).	●
Performance measures should be in place soon and the results included in the departmental performance report to Parliament (paragraph 5.88).	○
The Department should ensure that its human-resource management information is accurate and up-to-date (paragraph 5.88).	○

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Important changes since 2002

2.6 The Canadian Forces are undergoing significant changes to adjust to new security challenges and operational demands. In its reports on plans and priorities published since 2002, National Defence reiterates the importance of ensuring that the Canadian Forces have the right mix of personnel, equipment, training, and doctrine to meet commitments. To achieve that right mix, it wants to improve recruitment and retention and to modernize human resources management.

2.7 In April 2005, a new Defence policy statement designed to reorganize and retool the Canadian Forces was issued. It articulated a new vision for the Canadian Forces and strengthened transformation efforts. To do this, the policy statement puts recruitment and retention among its top priorities.

Focus of the audit

2.8 This follow-up audit examined the extent to which National Defence has been able to recruit enough personnel into the Regular

Force to meet its requirements each year. We looked at how National Defence plans the number and types of recruiting targets it establishes each year. We also looked at how it attracts, processes, and selects recruits to see whether the Department is addressing issues that have prevented the Regular Force from getting the numbers and types of recruits it needs.

2.9 We also examined the management of occupations in the Regular Force, composed of the Navy, Army, and the Air Force. We looked at the Canadian Forces' **trained effective strength** to determine whether National Defence has addressed problems that have prevented it from growing. We reviewed actions taken by the Department to determine why members leave the military and to address those reasons.

Trained effective strength—The number of members in the Regular Force who are trained and available for duty.

2.10 In this follow-up report, we looked at expansion plans for the Regular Force and whether National Defence has the organization and information it needs to ensure that its human resource management is part of the overall transformation of the Canadian Forces to meet the vision of the new Defence policy statement.

2.11 More information about the audit objective, scope, approach, and criteria can be found at the end of the chapter in **About the Audit.**

Observations and Recommendations

Shortages in the Regular Force

Increasing the number of trained members available for duty takes time

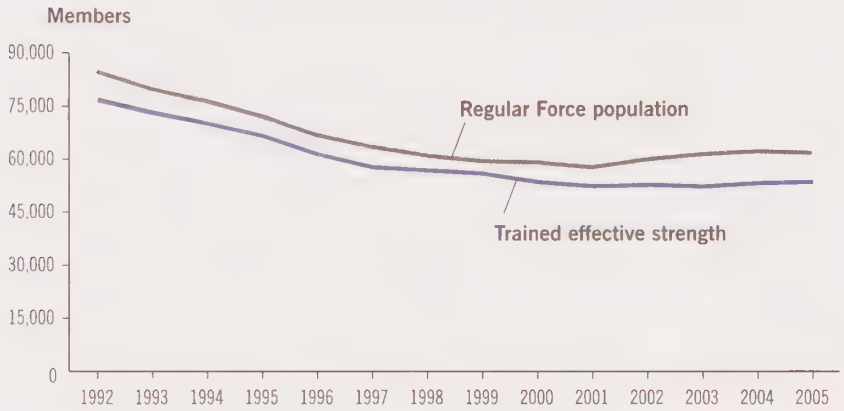
2.12 In 2002, we found that the trained effective strength of the Regular Force was falling, and this trend needed to be reversed (Exhibit 2.2). We were concerned about indications predicting that more members would leave the Canadian Forces than would be recruited. In March 2005, the trained effective strength was about 87 percent of the total Regular Force, lower than its average historical level of 92 percent. We found the Department has been successful in stopping the decline in the trained effective strength. The recruiting group enrolled about 20,000 new members for the Regular Force in the last four years, but the increase in the trained effective strength was limited to about 700. Recruiting data indicate that the increase was affected by the following:

- Attrition from the entire Regular Force was about 16,000 members.

- The number of recruits in training increased by about 3,000. Training can take from two to seven years depending on the occupation.

2.13 Furthermore, recruiting is limited because the size of the Regular Force is restricted to 62,300 members. Until more recruits complete the training process, it may take some time for the trained effective strength to recover its numbers.

Exhibit 2.2 Number of trained effective strength in the Regular Force from 1992 to 2005



The Department has been successful in stopping the decline.

Source: National Defence

Staffing is still a concern

2.14 National Defence data showed that at the time of this audit there were about 2,400 vacant positions, which is an improvement from the situation we found in 2002. In 2005, we found that twenty-nine occupations were understaffed by ten percent or more and, even with planned recruitment and training, the Department estimates that it will take two or more years to recover. Twenty-six occupations have between five to ten percent vacancies, which may take one to two years to recover.

2.15 Other occupations were found to be overstaffed, which in turn, can limit how many people could be brought into the military. Twenty-four military occupations had about 940 personnel in excess—which is higher than what we had found in 2002. National Defence explained that overstaffing occurs because it needs to replace people who are leaving before they retire or are released. In addition, the length of time required for new recruits to complete occupational training creates some degree of overstaffing.

2.16 The Navy, Army, and Air Force occupations are experiencing uneven, persistent shortages in almost half of their 69 specific occupations. Many of the occupations that were facing shortages in 2002 are still in the same situation today.

2.17 Shortages exist in 17 of the 33 support occupations common to the Navy, Army, and the Air Force. About four percent of positions in those 17 occupations are vacant. National Defence has improved the staffing levels of some occupations such as dentist, lawyer, and chaplain. However, some support occupations such as doctors, ammunition technicians, and logistics officers, which are critical for deployments, continue to be understaffed.

The recruiting numbers in the Strategic Intake Plan barely meet needs

2.18 National Defence uses the Strategic Intake Plan to establish the number of members to recruit and train annually. Several times each year this plan is reviewed and adjusted to take staffing needs into account. We reviewed the planning process and found that it was sound. We also found that in recent years, because of personnel budget restrictions, the targets in the Strategic Intake Plan did not match the stated requirements of the Navy and Air Force. Furthermore, National Defence has estimated that it will take five years to fill all the positions required for operations.

2.19 Because of the limits of the National Defence training system to absorb new recruits, and the need to stay within the allowable size of the Regular Force, recruitment targets were reduced between 2003 and 2005. In fact, targets dropped from 7,000 new recruits in 2001 and 6,200 in 2002, to fewer than 4,500 in 2003 and in 2004.

2.20 Since 2002, National Defence has come close to achieving its recruitment targets but, in 2005, the number of recruits exceeded the number of releases by less than 200. Despite National Defence's results, we are concerned that the number of recruits is barely replacing the members leaving (Exhibit 2.3).

Attrition is expected to increase

2.21 National Defence data show that there is a large concentration of members in their later years of service who are approaching the time when they will be eligible for retirement. Approximately 50 percent of Regular Force personnel have 15 years of service or more (Exhibit 2.4); thus they are either already eligible to leave or will soon be. Because of the potential for a large number of military personnel to leave over the

next five to ten years, National Defence is predicting that attrition will rise. As the exhibit shows, there are few members behind those leaving to fill in the gap.

2.22 National Defence data show that attrition rates are also higher than average in the early years when members are getting initial training and adjusting to military life. Currently, about 31 percent of Regular Force personnel have less than six years of service. Since so many members are in their early years, the average rate of attrition is expected to increase in coming years.

Exhibit 2.3 Numbers of members recruited and released

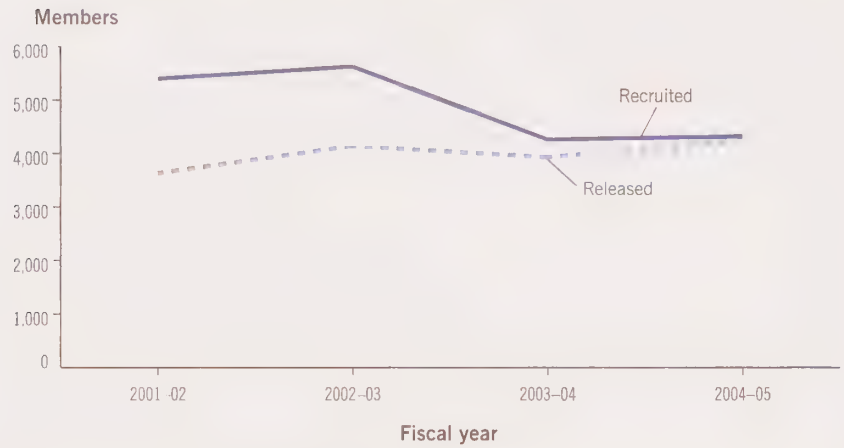
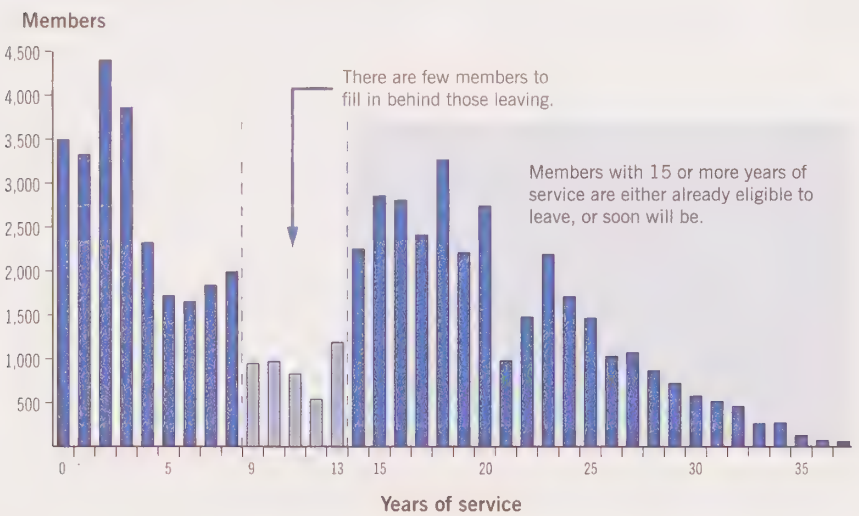


Exhibit 2.4 Distribution of the population of the Regular Force



Source: National Defence

2.23 The combined factors of higher rates of attrition and larger numbers of people in the early and later periods of their service are expected to lead to a higher overall attrition in coming years. While attrition in the Regular Force has averaged six percent since 2000, National Defence expects an increase over the next 10 years.

2.24 For non-commissioned members (NCMs)—those who are not officers—attrition for medical reasons has almost doubled since 2001. Medical releases have averaged about 24 percent of total attrition for NCMs and 10 percent for officers over the last five years. National Defence is planning to conduct a study to identify the determining factors of the increase in medically related attrition, for example, age, gender, occupation, deployments, or postings.

National Defence is planning to expand the Regular Force by a total of 5,000 members

2.25 National Defence has stated that to remain sustainable, the size of the Regular Force must be expanded by 5,000 members to over 67,000. We reviewed the planning documents for the personnel increase in each type of occupation. We found that they included a detailed analysis supporting the increases and the impacts on training schools and capital costs. However, the planning documents did not look at the impacts on advertising and attraction activities needed to bring in more applicants. To achieve this 5,000-member expansion, National Defence plans to increase its recruitment target to about 5,800 each year until 2010.

The Canadian Forces are recruiting from a changing demographic

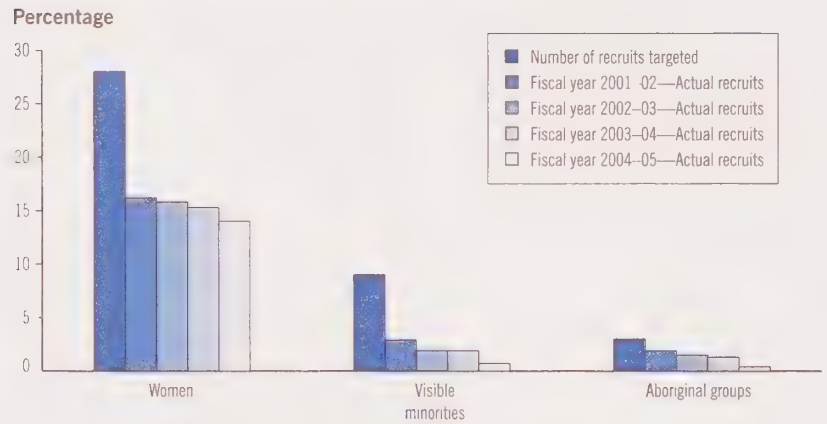
2.26 The Regular Force is competing for suitable candidates in a tight labour market. National Defence targets Canadians aged 16 to 34 who are physically fit and inclined to join the military. Young males have traditionally formed a large part of the military. The Conference Board of Canada has reported that the male population in this age group will grow by only 7.8 percent over the next 10 years, and the portion of women will increase by 9.2 percent over the same period.

2.27 A National Defence survey of this specific target group indicated that only six percent were interested in joining the Regular Force, although about 30 percent said they would consider joining if their education was paid for or if they were offered an entry bonus.

2.28 Statistics Canada data show that Canadian demographics are changing. Young Canadians from visible minorities are becoming an increasing portion of the population. National Defence has also

conducted demographic studies and recognizes that it needs to recruit young women and young Canadians from Aboriginal and visible minority groups; it has set targets for these groups. However, so far the Department has not been successful in meeting these targets. The number of women recruited into the military has steadily decreased since our last audit in 2002, and the same trend appears for visible minorities and Aboriginal people (Exhibit 2.5).

Exhibit 2.5 Success in recruiting diverse groups is declining



The recruitment of diverse groups is below target and is decreasing.

Source: National Defence

Attracting, processing, and selecting recruits

2.29 Although National Defence has opened some recruiting offices and closed others to be closer to its target populations, departmental data show that applications for the Regular Force have declined over the last two years.

2.30 We expected National Defence to have a policy to attract the required target populations. The policy is needed to guide objectives, strategies, and programs, combined with a clear accountability framework for achieving results; but the Department was unable to provide us with such a policy. We asked the Department for a comprehensive plan or strategy that guides the 39 recruiting centres and detachments; National Defence provided us with a schedule of events, such as outreach activities at schools and trade shows.

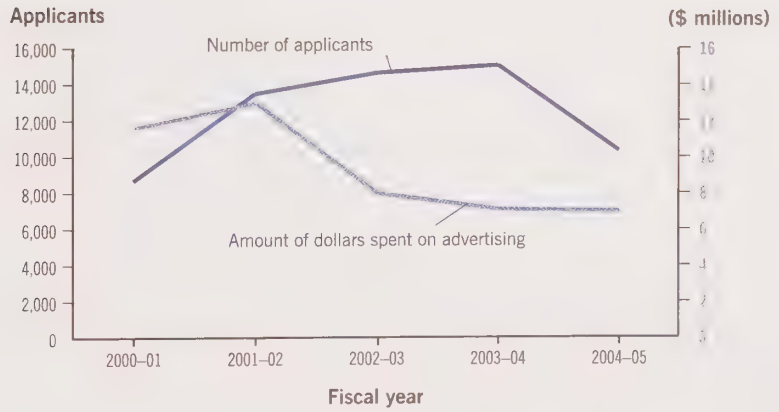
2.31 In June 2005, the Department released a manual on how to develop a recruitment strategy, with information on research, advertising, and outreach activities. We found that the responsibility for research and advertising is shared between the recruiting

directorate and the public affairs group, although accountability ultimately rests with the Assistant Deputy Minister-Military Human Resources. We are concerned that this sharing of responsibility for attracting recruits means that efforts may not always be co-ordinated and can affect results. National Defence needs a comprehensive plan to guide and co-ordinate national, regional, and local activities for attracting and recruiting applicants.

2.32 The advertising budget to attract applicants to the Canadian Forces decreased by about 50 percent, from about $13 million in 2001–02 to about $7 million in 2004–05. National Defence explained that this drop in advertising dollars accounted for a drop in applications to join the military. However, we did not see this pattern (Exhibit 2.6) and noted that advertising was only one of several influences on prospective recruits that led them to inquire about joining the military. National Defence needs a comprehensive plan to attract enough good applicants from its target population.

2.33 In order to have the Regular Force grow by 5,000 new members over the next few years, the military needs more applicants from which to make appropriate selection decisions. We found that at the time of this audit, there was no plan in place to try and attract more applications to the military from which National Defence could increase its number of suitable recruits. National Defence officials informed us that they are drafting a national recruiting campaign that looks at both attracting and recruiting.

Exhibit 2.6 A comparison of advertising dollars with the number of applicants to the Regular Force per year



Advertising dollars decreased in 2001–02, but the number of applicants decreased in 2003–04.

Source: National Defence

Recruiting process loses many applicants

2.34 The recruiting process needs to be able to respond quickly to fluctuations in the number of applications received. National Defence needs to process applications in a timely and effective manner, so that it does not lose too many good recruits through lengthy delays. However, recruiting can be a lengthy process; many potential candidates may find other work or change their minds about a military career during the period between application and enrollment in the Canadian Forces.

2.35 The recruiting centres received an average of 13,500 applications per year to the Regular Force over the last three years. Although half of all applicants complete the first recruitment step—the aptitude test—within three weeks of applying, the remainder of the process can delay enlistment from 90 days to more than a year (see Exhibit 2.7). During this lengthy process, National Defence data show that in about 28 percent of cases (almost 3,800 of the 13,500 applicants), either they voluntarily withdrew their applications or contact was lost between the recruiting centre and the applicant (Exhibit 2.8). We are concerned that deficiencies in the recruiting process will affect the Department's ability to increase the size of the Regular Force by 5,000 over the next five years.

2.36 In the past, National Defence had a large number of screened candidates to choose from, including an inventory of suitable applicants from which it could draw as needed. However, with the recent decline in applications and the need to expand recruiting, that inventory is being reduced faster than it can be filled. National Defence informed us that this inventory of applicants for many occupations is now empty.

2.37 National Defence is starting to use better technology for recruiting. For example, the recruiting Web site provides detailed information about military occupations; however, early in the audit, it did not accept on-line applications. Applicants had to apply in person at a recruiting centre or mail in an application. National Defence has recently implemented an "e-recruiting" project to accept on-line applications; it also allows applicants to track their status, from the time of application to enlistment.

2.38 **Recommendation.** National Defence should review its processes to attract applicants to ensure that it has a sufficient number of applicants from which to draw suitable candidates.

National Defence's response. National Defence agrees with this recommendation.

National Defence has reviewed its processes to attract applicants. A comprehensive National Recruiting Campaign, supported by a National Recruiting Attraction Plan, new advertisements, and appropriate advertising funding will increase the number of applicants from which to select suitable candidates. Performance measures are being developed, and results against these measures are expected by 2007.

Exhibit 2.7 Delays in recruiting

The following are some of the steps and delays applicants face during the recruitment process.

Aptitude test. After National Defence receives an application from a potential candidate, it opens a file and conducts an initial contact interview with the candidate. Then the applicant takes the Canadian Forces Aptitude Test. Fifty percent of applicants complete the aptitude test within 21 days. Heavy workload at peak periods and incomplete documents extend the time for the other fifty percent.

Medical fitness. The main challenge encountered at this step is the delays in completing the screening of applicants who have medical problems (sixty percent of all applicants). Forty percent of the applicants—those with no medical problems—pass the medical processing in three days. However, processing applicants with medical problems increased the complexity of medical screening. Delays often occurred when the recruiting medical officer requested the opinion of a specialist. Half of the applicants with medical problems had to wait from 4 to 21 days to pass the medical. The remainder of the applicants with medical problems waited from 22 days to more than six months to complete this step. Further delays can occur during the final file review at the recruiting headquarters. In the end, only about nine percent of applicants actually failed the medical screening.

Physical fitness. About 12 percent of applicants fail the Canadian Forces Physical Fitness Test, which was instituted in 1997. There can be delays in this step, caused by, for example, the applicant not being available due to medical issues.

Security requirements. Applicants who are not Canadian citizens, or who are citizens but have resided outside of Canada for the 10-year period immediately preceding their application, require a "pre-security assessment" that can cause delays of months or even years, depending on the circumstances. The time required for a pre-security assessment has increased, which discourages many applicants. Landed immigrants can be enrolled in the Canadian Forces in very rare circumstances, subject to a satisfactory assessment, as directed by the head of the Canadian Forces. Recent efforts to streamline security requirements may reduce the processing time for some applicants.

Selection process. Since most selection boards sit only once or twice a year, many candidates have to wait to be assessed. About 50 percent of candidates are selected within 65 days of completing the previous recruitment steps. However, 47 percent of applicants wait between 65 and 300 days to have their application reviewed by the selection board and finalize the recruitment process.

Source: National Defence

Exhibit 2.8 National Defence recruiting process



Note 1: Values are estimates based on a National Defence statistical sample.

Note 2: Many of the applicants who fail physical training, drug questionnaires, the aptitude test, and even some medical portions of the selection process are not permanently rejected. Retesting/reconsideration can occur in most cases if the applicant chooses to reapply.

Source: National Defence

2.39 Recommendation. National Defence should take immediate action to correct problems that cause applicants to unnecessarily withdraw from the application process.

National Defence's response. National Defence agrees with this recommendation.

National Defence will increase the number of personnel assigned to recruiting centres and will put in place a monitoring system that allows us to determine accurate numbers of applicants, their dispositions, and the time for processing. With this information, we will act to reduce unnecessary withdrawals and delays. We will aim to have this in place in 2007.

Applicant assessment

National Defence cannot ensure it is recruiting the right people

2.40 National Defence measures the military potential of its applicants so that it can evaluate and predict the likelihood of completing training and integrating into the Canadian Forces. Military potential is based on eleven measures—academic achievement, aptitude test results, and nine personal attributes such as teamwork, conformity to rules, and physical endurance.

2.41 National Defence has validated its aptitude test and shown it to be a reliable instrument for predicting success in training. However, we found that the assessment interview used to measure the nine personal attributes has not been validated. The Department was not able to demonstrate that its assessment interview adheres to generally recognized technical and professional standards, which it adopted and defined in the National Defence Personnel Selection Manual. As well, the Department could not provide evidence that the personal attributes it measured were valid predictors of military suitability or that when using the interview as an assessment tool, all recruiters were assessing the same attributes the same way. As a result, National Defence cannot ensure that, when it measures personal attributes, it is accurately predicting the suitability of applicants.

2.42 In 2004, the Department approved a revised recruiters' handbook containing comprehensive information on processing, documenting, selecting, assessing, and enrolling candidates. This handbook has the potential to improve the consistency and the reliability of assessment interviews because it has clear procedural guidelines and reflects good personnel assessment practices. However, National Defence does not gather information on the performance of its recruiting centres. It does not track the success of its recruiting centres in identifying and enrolling suitable candidates who meet military requirements and become part of the trained effective strength.

2.43 In February 2005, the Department approved an assessment directive with different criteria and procedures for assessing applicants, but these still need to be validated. Department officials informed us that the validation process was under way. Even though the Department has taken steps to improve the way it evaluates candidates, it still cannot provide assurance that candidates are being evaluated for the right things.

2.44 National Defence recognizes that the assessment interview is an important tool that needs to be administered by skilled and

knowledgeable recruiters. The *Canadian Forces Occupational Personality Attributes for Recruiters* states that Regular Force members who possess attributes such as strong interpersonal and behavioural skills and the ability to analyze information, behaviours, and ideas can be assigned as recruiters responsible for assessing the military potential of applicants. New recruiters undergo about 25 days of training after which they begin assignments at recruiting centres to assess applicants and make decisions on their suitability. A personnel selection officer monitors them at least twice a year. However, the occupational requirements for being assigned as a recruiter/interviewer do not include the need for background, knowledge, or skills in personnel selection or industrial or organizational psychology, as suggested in the National Defence Personnel Selection Manual.

2.45 National Defence has established minimum standards that candidates must meet or exceed in order to be selected. The minimum standards are a balance of three things—the number of new recruits the military needs, the availability of trainable applicants, and the amount of tolerance in the system for training failures. The Department has stated that the quality of recruits takes precedence over quantity. However, because applications are declining, it has reached a point where the Department is accepting more candidates who have only met the minimum standard for the occupation they have chosen. However, the Department was not able to provide us with information on how many recruits have only met the minimum or with information about the impact this has on training failures and the cost of training. National Defence must protect the integrity of its selection process and ensure that the minimum standards are set at the right point.

2.46 **Recommendation.** National Defence should continue its work to ensure that its personnel assessment instruments and selection decisions are based on recognized technical and professional standards and are valid predictors of candidate suitability.

National Defence's response. National Defence agrees with this recommendation.

National Defence will continue to collect information on the criteria and procedures introduced in our assessment directive of February 2005 in order to validate that our selection tools are predicting candidate suitability. We have set the end of 2008 as a target date for completion of this validation. The issue is iterative and continuous. Contingent on results of this validation, it will be essential to fine-tune criteria and their scoring on a regular basis.

2.47 Recommendation. National Defence should ensure that its recruiters have the necessary knowledge and skills needed to recruit and select suitable candidates.

National Defence's response. National Defence agrees with this recommendation.

National Defence will continue to improve the quality of recruiting staff through enhanced selection and training measures, including the establishment of a permanent Recruiting Training Centre in 2007.

National Defence faces ongoing training challenges

Basic training schools—Schools where military instructors teach general military knowledge, drill, first aid, physical fitness, and weapons training to all military personnel.

Post-basic training—Second level of training where instructors teach the specific skills members need to qualify for their military occupation such as Army combat engineer.

2.48 In our 2002 audit, we found that **basic training schools** responded quickly to the need to train up to 6,000 new recruits annually. However, we found the next step, **post-basic training**, was showing signs of strain; bottlenecks were starting to form in training schools for some occupations.

2.49 In 2001, National Defence increased the number of recruits. In 2002, we found that, although the recruits had completed basic training, many of them were still waiting for occupational training due to limitations in the post-basic training schools. Since then, we found that limitations in the capacity of the training system remain an issue. As part of its current planned expansion, National Defence has stated that it intends to get more instructors into the schools. However, these instructors are often in short supply because they are needed to fill operational demands in the Forces.

Managing military attrition

Impacts from the Retention Strategy and Action Plan have not materialized

2.50 In 2001, National Defence developed the Canadian Forces Retention Strategy and Action Plan to keep the focus on retaining military personnel in the next decade. At that time, National Defence recognized that the overall attrition rate—between six and seven percent—was at or below historical levels. However, it also recognized that the Regular Force was below the desired level of staffing and that there was increasing competition for a limited pool of young candidates. In the 2001 Retention Strategy and Action Plan, the Department identified several issues related to attrition, including

- an above-average attrition in some military occupations;
- a large number of experienced members who were, or soon would be, eligible for a pension; and
- the need for a better return on training investment.

2.51 Although the retention strategy required that timelines be established and progress monitored, the Department was not able to provide us with evidence that this has occurred. We found that National Defence has made some progress, such as monitoring and analyzing attrition data and developing a retention survey.

2.52 National Defence conducted retention surveys between 2002 and 2004 on the reasons people intend to leave. It found that members have given reasons, such as

- a lack of fairness in the Canadian Forces,
- uncertainty about the future of the Canadian Forces,
- leadership and bureaucracy, and
- career concerns.

2.53 We found that since 2002, National Defence has continued to work on measures that it expects will have a positive impact on retaining members. These include, for example, quality-of-life initiatives and a new policy to help transfer members between the Regular and Reserve Forces. Department officials informed us that they are in the process of reviewing career management practices.

2.54 We reviewed the progress by National Defence to address the attrition issues raised in the 2001 retention strategy. National Defence initiated a retention-intervention process to address higher attrition in some military occupations. The process was intended to identify occupations with potential attrition problems and to develop measures to address them. The Department used its retention survey to examine 32 occupations between 2002 and 2004 to determine members' intentions to leave. However, this survey was designed to identify problem areas generally applicable to the Canadian Forces and is limited in its ability to identify specific potential issues within occupations. As a result, many of the issues identified were broad in nature, and few changes were made that addressed military-occupation specific concerns.

Terms of service have changed to help retain members

2.55 National Defence "terms of service" are the agreements between the Canadian Forces and its members to provide military service. Terms of service provide a timeline and structure for engaging and discharging members, and the terms vary depending on occupation and stage of career. Terms of service were originally designed to release 80 percent of members at or before 20 years of service. They were based on Cold War conditions and the availability of new recruits.

Recognizing that operational and external factors have changed, National Defence began to update the terms of service.

2.56 To retain more experienced personnel, the Department extended eligibility for pension from 20 to 25 years of service. However, this change may not affect the attrition of members who remain under the original terms of service. We estimate that the first group of Canadian Forces personnel who will serve for 25 rather than 20 years will be officers who completed their initial engagement in 2005 and re-enlisted under the new terms of service. They may not begin to serve the extended five years until around 2013 and will be required to serve until about 2018 or later before being eligible for release with a pension.

2.57 To keep experienced personnel, the Department no longer gives a lump sum to officers who leave after nine years of service, and it has raised the compulsory retirement age from 55 to 60. National Defence has advised us that the number of members serving past age 55 has increased from about 200 in 2002 to about 350 in 2005. The Department directed that all eligible members completing 20 years of service be offered an extension. However, when we asked about the results of this measure, National Defence was unable to provide information on the number of eligible members or if they had all been offered an extension.

Early attrition lowers the return on training investment

2.58 In some occupations, the loss of personnel early in their service can be costly if members leave before the Department can benefit from its investment in training. We looked at the departmental data for a sample of 20 military occupations and found that, after only seven years, most had lost over one third of the group that they had recruited and trained.

2.59 For example, while the military occupation of Army combat engineer has an average attrition rate of about 6 percent, the rate of early-career attrition in this occupation is higher. National Defence data show that, by the end of their fourth year in the military, about 35 percent will have left. The Department estimates that it costs about $220,000 to train a combat engineer up to the fourth year of service.

2.60 Army electrical and mechanical engineering officers have an average attrition rate of about 6 percent. It costs about $200,000 to train these engineering officers for the first seven years, four years of which are typically spent in university. However, after seven years of service, about 35 percent will have left the military. This group

typically accepts only around 35 recruits each year; this means that after seven years, only 22 officers are left from the initial group.

2.61 Other military occupations have higher early-career attrition rates and higher training costs. About 71 percent of military physicians leave within ten years of joining the Canadian Forces, during which time the Department has subsidized their education for about five years. Two in five military nurses leave by the time they have completed seven years of service.

2.62 Early career training costs vary by occupation, and National Defence has changed the terms of service to better match the initial term of service with training investment. The initial term of service now varies from three to nine years depending upon the occupation and training required.

2.63 **Recommendation.** National Defence should continue to develop and implement specific corrective measures that better focus on the attrition issues it identified in its 2001 Retention Strategy and monitor the results.

National Defence's response. National Defence agrees with this recommendation.

National Defence will continue to identify conditions of military service that affect attrition and focus interventions on those that are amenable to policy/program solutions. A retention strategy will incorporate continuous improvements and therefore will remain flexible.

Managing military human resources

A single, recognized authority is necessary

2.64 Best human-resources management practices suggest that to achieve Defence core business objectives, the Assistant Deputy Minister-Military Human Resources needs to be an equal partner in the strategic decision-making process. This is necessary for a unified direction in managing military human resources in the Canadian Forces.

2.65 National Defence has been facing serious organizational challenges to military human resources management. Over the past five years, external and internal studies have stressed that the responsibility and accountability of the Assistant Deputy Minister-Military Human Resources has not been clearly defined or accepted within the Department. The studies reported that the Navy, Army, Air Force, and other stakeholders considered this function to be an advisory position, with no decision-making authority.

2.66 We found that some commanders had developed their human-resources management processes and policies without the required direction from the Assistant Deputy Minister-Military Human Resources. This resulted in inconsistent and fragmented policies and practices in the Canadian Forces human-resources management system and prevented the implementation of a single, Canadian Forces strategic human-resources direction aligned with the core business direction.

2.67 In July 2004, the Department revised and approved, in principle, new terms of reference for the Assistant Deputy Minister-Military Human Resources. It stated that the position is the authority in National Defence for military human-resources management. However, we found that this authority was not being enforced. In November 2005, the Department endorsed the responsibilities of the Assistant Deputy Minister and again recognized this position as the single authority to manage the Canadian Forces personnel system. It also approved in principle the concept of a framework for the integrated human resources management of the Canadian Forces. The Department plans to further delineate the responsibilities and accountabilities of the Navy, Army, and Air Force, and other stakeholders in managing human resources. This recent decision is a step forward to improving the effectiveness of military human resources management.

Managing military human resources strategically is fundamental

2.68 In 2002, National Defence developed the Military Human Resources Strategy 2020 in response to its Defence Strategy 2020, which had been put into effect two years earlier. There are clear links between the two strategies. As the basis for developing the strategy for managing human resources for the next 20 years, National Defence undertook a comprehensive assessment of internal and external factors affecting the management of its military human resources.

2.69 To ensure that the strategy to manage military human resources supports the National Defence strategic direction, the Department needs to do more work to assess the impact each has on the other. This assessment would provide information to ensure that military human-resources management planning is relevant and adequate.

2.70 The Military Human Resources Strategy 2020 served as the foundation for other subsequent human resources management tools. These tools, however, have yet to be approved. National Defence has

begun working on performance measures to assess the effectiveness of its human resources strategy and the progress of its implementation.

2.71 With the publication of the new Defence policy statement in April 2005, National Defence has embarked on a significant transformation project. Transforming the Canadian Forces involves people, technology, ways of conducting operations, and ways of thinking. It also requires a fully integrated and unified approach to operations. A key challenge for military human resources management is to assess the impact these changes will have on its policies, systems, and practices, while ensuring consistency.

2.72 During these past years, military human resources management concerns were often segregated from National Defence strategic considerations. However, significant progress has been achieved recently to align these activities. We found that personnel from the Assistant Deputy Minister-Military Human Resources Group have been participating in transformation committees and have contributed to identifying obstacles and improvements for implementing the new defence policy and vision. National Defence needs to develop a strong strategic military human resources vision and direction, and it needs performance measures that show progress toward contributing to the Canadian Forces' transformation goals.

Conclusion

2.73 Overall, National Defence has made satisfactory progress in responding to our 2002 recommendations. It has shown some improvement in recruiting the military personnel it needs to meet its operational requirements. But, since 2002, the trained effective strength of the Regular Force has grown by only about 700 members, and there is a shortage of about 2,400 qualified people to meet the needs of the Canadian Forces to accomplish their military tasks.

2.74 The Department has not been able to improve its recruiting of Aboriginal people, visible minorities, or women since our 2002 audit. Despite an increase in the youth population of these groups, the number of these recruits joining the Regular Force is declining. Even though the Department has carried out studies on the demographics of the Canadian labour force, is promoting diversity, and is spending $1.5 million on diversity recruiting, these efforts are not achieving results.

2.75 We also found that military occupations that were below their required staffing levels in 2002 are still experiencing problems today. The Navy, Army, and Air Force have improved the staffing levels of some critical occupations, but there are still persistent shortages in both the support and specific occupations.

2.76 Even though the Department has taken action to address personnel shortages, we found that intake is barely replacing the number of members who are leaving. The recruiting and selection process is not meeting the needs of the Canadian Forces, and the Department needs to address problems that prevent it from getting the right number of suitable candidates from which to select recruits.

2.77 In 2002, we found that the Department needed to gather better information on attrition and to develop more effective retention initiatives. Since then, National Defence has been analyzing reasons for attrition and ways to address why members leave. Although some steps have been taken to address concerns, attrition in early and later years is still expected to increase, and the Department needs to continue its work to better identify what actions it should take to ensure that attrition does not become problematic.

2.78 Although National Defence has taken steps toward integrating concerns about the management of the military human resources in the decision-making process, it needs to continue to assess the impacts that the Canadian Forces' goals for transformation will have on the military human resources system. Under the new terms of reference for the position of the Assistant Deputy Minister-Military Human Resources, the Department has increased its ability to effectively manage an integrated human resources management system for all the Canadian Forces in line with the new vision of the 2005 Defence policy statement.

About the Audit

Objectives

The overall audit objective was to assess the progress National Defence made in addressing concerns raised in Chapter 5 of our 2002 Report on military recruiting and retention. This follow-up audit assessed the extent to which measures put in place by National Defence, since 2002, to manage regular force recruitment and retention, have resulted in improvements that are consistent with its strategic direction.

Scope and approach

Our audit focussed on the framework and processes for recruiting and retaining military personnel. We assessed the recruitment and retention policies and practices of National Defence through site visits, analysis, and interviews. Our audit involved mainly the office of the Assistant Deputy Minister-Military Human Resources but also included the offices of the Assistant Deputy Minister for Public Affairs.

Criteria

We followed up on recommendations made in our previous audit of military recruiting and retention in 2002. We expected that National Defence would have in place

- accurate information and guidance for determining human resources needs to meet current and future Canadian Forces' operational demands,
- a recruiting process and measures to recruit and train for a suitable and sustainable military workforce, and
- appropriate measures to achieve its retention strategy.

Quantitative information in this chapter is based on data provided by the Department. These data should be treated as unaudited.

Audit work completed

Audit work for this chapter was substantially completed on 20 January 2006.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 2. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
Attracting, processing, and selecting recruits	
2.38 National Defence should review its processes to attract applicants to ensure that it has a sufficient number of applicants from which to draw suitable candidates. **(2.29–2.37)**	National Defence agrees with this recommendation. National Defence has reviewed its processes to attract applicants. A comprehensive National Recruiting Campaign, supported by a National Recruiting Attraction Plan, new advertisements, and appropriate advertising funding will increase the number of applicants from which to select suitable candidates. Performance measures are being developed, and results against these measures are expected by 2007.
2.39 National Defence should take immediate action to correct problems that cause applicants to unnecessarily withdraw from the application process. **(2.29–2.37)**	National Defence agrees with this recommendation. National Defence will increase the number of personnel assigned to recruiting centres and will put in place a monitoring system that allows us to determine accurate numbers of applicants, their dispositions, and the time for processing. With this information, we will act to reduce unnecessary withdrawals and delays. We will aim to have this in place in 2007.
Applicant assessment	
2.46 National Defence should continue its work to ensure that its personnel assessment instruments and selection decisions are based on recognized technical and professional standards and are valid predictors of candidate suitability. **(2.40–2.45)**	National Defence agrees with this recommendation. National Defence will continue to collect information on the criteria and procedures introduced in our assessment directive of February 2005 in order to validate that our selection tools are predicting candidate suitability. We have set the end of 2008 as a target date for completion of this validation. The issue is iterative and continuous. Contingent on results of this validation, it will be essential to fine-tune criteria and their scoring on a regular basis.

Recommendation	Department's response
2.47 National Defence should ensure that its recruiters have the necessary knowledge and skills needed to recruit and select suitable candidates. (2.40–2.45)	National Defence agrees with this recommendation. National Defence will continue to improve the quality of recruiting staff through enhanced selection and training measures, including the establishment of a permanent Recruiting Training Centre in 2007.
Managing military attrition	
2.63 National Defence should continue to develop and implement specific corrective measures that better focus on the attrition issues it identified in its 2001 Retention Strategy and monitor the results. (2.50–2.62)	National Defence agrees with this recommendation. National Defence will continue to identify conditions of military service that affect attrition and focus interventions on those that are amenable to policy/program solutions. A retention strategy will incorporate continuous improvements and therefore will remain flexible.

Chapter

3

National Defence

NATO Flying Training in Canada

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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National Defence
NATO Flying Training in Canada

Main Points

What we examined

We examined whether National Defence has made satisfactory progress in addressing the concerns we raised in 2002 about its management of both the NATO Flying Training in Canada program and the contract used to purchase the training. At that time, we reported that by December 2001 the Department had paid about $65 million for training that the program had been unable to provide, largely because of problems with the aircraft. This time we followed up to determine whether National Defence has properly calculated any further losses incurred since December 2001 through payments for training that did not take place and whether it has recovered all money owed. We also examined whether the Department has resolved the problems in its own management of the program, which had prevented it from taking full advantage of the training it had purchased.

Why it's important

This pilot training program involves a $3.4 billion, 20-year contract under which many payments are fixed. While demand for pilot training can fluctuate over 20 years, ongoing underuse of the available training could prove costly.

What we found

- Overall, National Defence has made satisfactory progress in resolving the problems we found in 2002, but it is still not using all the training it is paying for. It has negotiated a settlement with the contractor for the training missed up to December 2002, when the program began meeting contractual expectations. The contractor, National Defence, and Public Works and Government Services Canada have calculated that the value of the missed training totals about $89 million. The contractor and the Crown have agreed to a settlement proposal, which has been formally implemented in a contract amendment effective 19 December 2005. The agreement recognizes that the Crown has already received about $39.5 million in benefits. A further $20.5 million is held in trust for the Crown, but the timing for payment is yet to be determined. The amendment also provides National Defence with further opportunities to obtain additional training.

- National Defence is still unable to enrol enough pilots in the program to use all the training available. Since the contractor is now meeting its contractual obligations, the Department bears the cost of paying for any unused training capacity. We calculated that since December 2002, the Crown has paid about $39 million for flying training that it could not use. It appears that the Department has no recourse to recover these losses, which we believe are likely to continue for at least a few more years.

The departments have responded. Public Works and Government Services Canada and National Defence have agreed with our recommendations. Their detailed responses follow the recommendations throughout the chapter.

Introduction

3.1 In May 1998, National Defence entered into a contract to purchase pilot training over 20 years as part of the NATO Flying Training in Canada (NFTC) program. In our 2002 Status Report, we reported on the implementation and management of this contract, noting concerns about management and the underuse of the program.

Key findings in 2002

3.2 Due to problems during the program's start-up, the amount of training that the contractor was able to provide was well below what the contract had stipulated. As a result, the program could not train the number of pilots National Defence said it needed to train. However, the Department was still making the fixed payments called for under the contract. By December 2001, the Department had paid about $65 million for training it missed, largely because of problems with the aircraft.

3.3 To make the program cost effective for both the Department and the contractor, National Defence had agreed to carry the program's cost with the option to sell some of its training positions to other countries. The Department marketed the program abroad and sold some of the available training positions. However, even with foreign sales, only 41 percent of the student positions National Defence had contracted for were filled by 2002. In response to our 2002 report, the Department stated it was confident that training capacity would be used more fully in the future.

Important changes since 2002

3.4 In September 2002, the House of Commons Standing Committee on Public Accounts required National Defence to present its plans for recovering the money the contractor owed. Initially, the Department responded that under the terms of the contract, the contractor did not have to provide financial compensation for training the Department did not receive. However, the Department did begin negotiating with the contractor to find ways to obtain value for the training missed. National Defence, Public Works and Government Services Canada, and the contractor have now agreed on the total amount of training missed. The contractor provided a settlement proposal, and Public Works and Government Services Canada and the contractor signed a contract amendment to implement the agreement effective 19 December 2005.

3.5 National Defence remains committed to the NFTC program and is still using it for basic flying and fighter pilot training. Other countries also use the program—mainly for training their fighter pilots, but in some cases, also for basic flying training. International participation remains critical to the program's success. Currently, six countries share the costs with National Defence, although the Canadian Forces remain the largest user.

Focus of the audit

3.6 This follow-up audit examined whether National Defence and Public Works and Government Services Canada have taken appropriate action to recover the full value for the payments the Department made for training missed. We examined how the amount of missed training was calculated and whether the settlement proposal provides the expected value.

3.7 We also looked at whether the contractor was now providing the number of training **sorties** paid for, under the terms of the contract, and whether National Defence was either using all those training sorties or selling the surplus to other countries. Where National Defence was not able to use training, we calculated the cost of this excess capacity and looked at whether the Department had plans for using it.

Sortie—A training flight.

3.8 More information about the follow-up objective, scope, approach, and criteria is at the end of the chapter in **About the Audit**.

Observations and Recommendations

The cost of unused training

A proposal for recovering the value of missed training has been accepted

3.9 The original $2.8 billion NATO Flying Training in Canada (NFTC) contract included both fixed and variable fees. With the participation of more foreign nations, the cost of the contract increased to about $3.4 billion. The contract payment schedule stipulates the fixed fees, which in 2005 comprised about 76 percent of the total, and cover the contractor's infrastructure costs and assets such as the aircraft and simulators. The variable fees, which make up the remaining 24 percent, are based on the number of pilots trained and their use of aircraft and supplies.

3.10 The contract requires National Defence to make fixed payments that average about $120 million each year for 20 years. Prior to signing

the contract, the Department determined how many pilots it needed to train each year and agreed to pay the fixed fees to secure that amount of training.

3.11 We found that, although National Defence had paid the fixed fees, the contractor was unable to meet its contractual obligations (about 81 training sorties per day) until December 2002. National Defence, Public Works and Government Services Canada, and the contractor have since determined that there was about $89 million of training missed from the start of the program until the time the contractor was able to meet its obligations. Missed training represents the training called for in the contract minus the amount National Defence actually used and the fixed costs paid, up to the end of December 2002. We examined how the three parties calculated the $89 million and found that they conducted due diligence in validating the value of training missed.

3.12 In May 2003, the contractor, Public Works and Government Services Canada, and National Defence began discussing a settlement. In February 2004, the contractor presented a written proposal to the Crown to recover the value of the missed training. In the proposal, the contractor stated it had already provided National Defence with about $27 million in training value and would provide about $12.5 million in ongoing flying instructor training and administrative services. The contractor recovered about $20.5 million by withholding payments to suppliers. This amount is being held in trust for the ultimate benefit of the Crown. The timing for when this amount will be made available is not yet decided.

3.13 The contractor also offered to provide additional basic training in 2020 and the option to sell more student positions in basic training to foreign militaries than was originally allowed in the contract. The value of this training is estimated by National Defence to be about $29 million (Exhibit 3.1).

3.14 In March 2004, National Defence asked Public Works and Government Services Canada to amend the contract to implement the February 2004 proposal from the contractor. In November 2004, National Defence and Public Works and Government Services Canada agreed that the contractor's proposal was a basis for negotiation and began reviewing the settlement.

Exhibit 3.1 **Terms of the contract amendment as agreed, effective 19 December 2005**

Value of training missed ($ millions)	**$89.0**
Benefits derived from operations	
Recognition of extra training received for pilot proficiency, pilot conversion, and extra flight instructor training	27.0
Revenue from sale of flight instructor training to foreign militaries until 2007	10.3
Administrative services already received and to be provided over the life of the contract	2.2
Total	**$39.5**
Amounts held in trust for benefit of the Crown	
Interest earned on funds and from payments to suppliers withheld due to late deliveries	11.5
Liquidated damages withheld from supplier A due to late delivery	6.0
Waiver by the contractor of claim related to late delivery from supplier B	3.0
Total	**$20.5**
Contract amendment opportunities for National Defence to obtain future value	
Additional basic training for National Defence in 2020 (value estimated by National Defence)	14.0
Additional sale of basic training to foreign militaries (value estimated by National Defence)	15.0
Total	**$29.0**
Current and potential future value of amendment	**$89.0**

Source: Public Works and Government Services Canada and National Defence

3.15 At the time of this audit, the Crown and the contractor had agreed that the settlement proposal was acceptable and completed a contract amendment to implement the agreement on 19 December 2005. All parties now need to agree on a timeline for receiving compensation.

National Defence needs to sell additional flying training and exercise future training options in 2020 to recover losses

3.16 Currently, the contract allows National Defence to sell basic training positions to other countries up to a maximum of 11 foreign students per year. The settlement proposal would allow National Defence to increase these sales to 15 students per year. The

Department must negotiate any sales itself. We found that National Defence has been less successful in obtaining foreign student commitments for basic training than for other training. Except for a handful of students trained on a special-trial basis, National Defence has not sold any of its basic training positions to other countries since 1999. The Department informed us that it has not yet done a study to examine the feasibility of selling additional training for foreign student pilots. We are concerned that the Department could find it difficult to generate extra revenue this way.

3.17 The December 2005 settlement also includes a provision for additional basic flying training for Canadian pilots after 2020. Therefore, this benefit will not be received for some time. National Defence will need to ensure that it has resolved its current underuse of the training available by 2020, and that it can enrol enough student pilots to use the training the contractor will make available. National Defence informed us that it has not yet examined the feasibility of this option because it is far in the future. However, it anticipates that it will need this training for pilots who will continue onto helicopter and multi-engine aircraft training as part of a different training contract that will still be in force at that time.

3.18 Recommendation. Public Works and Government Services Canada and National Defence should begin action to ensure that compensation is received in a timely manner.

The departments' response. Public Works and Government Services Canada and National Defence will follow up with the contractor and other relevant parties to ensure that funds due to Canada are paid promptly in accordance with the NATO Flying Training in Canada agreements. Other compensation, in the form of additional training, will be received in a timely manner based on Canada's training needs.

An additional $39 million was paid for unused pilot training

3.19 In response to our 2002 audit, National Defence had said it was confident that it would use the NATO Flying Training in Canada (NFTC) training capacity more fully as the program matured. The Department said the underuse was a reflection of the challenges inherent in starting up a new program of this complexity and magnitude. It explained that the problems caused by late deliveries of aircraft and equipment would not be repeated; thus training would not be underused. However, in 2005, we found that available pilot training was once again underused but for reasons unrelated to the NFTC start-up problems.

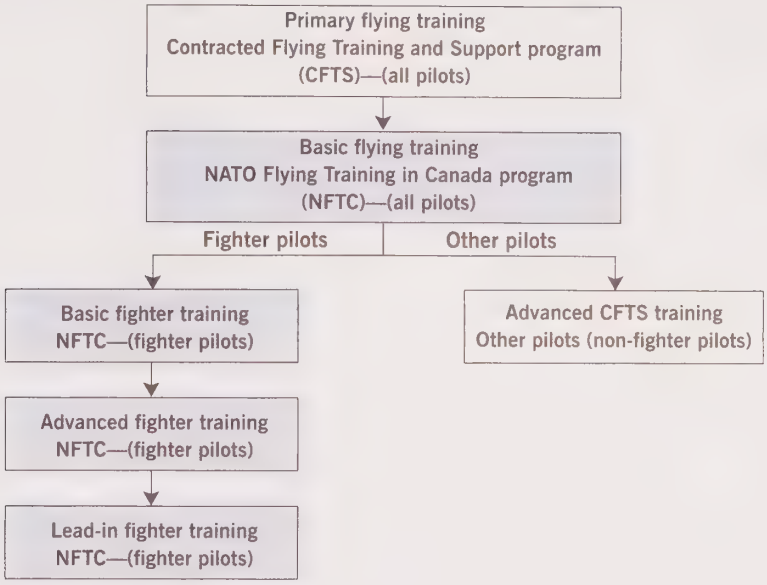
3.20 We found that, beginning in October 2002 the contractor had demonstrated that it could provide all the training National Defence required. It was able to maintain this performance level, and by the end of December 2002, National Defence and Public Works and Government Services Canada agreed that the contractor was now meeting its contractual obligations. Therefore, the Department's inability to utilize training it had paid for was no longer attributable to contractor problems.

3.21 Although from October 2002 onward, the program provided the number of training flights required, National Defence was, and continues to be, unable to take full advantage of this. Of about 654 student pilot training positions it paid for between the end of December 2002 and December 2005, the Department used only about 509 positions, or 78 percent. This is an improvement over the 41 percent use we found in 2002, but it still means that training positions are left empty. We estimate that the Department paid about $39 million for this unused training. Because this shortfall is a departmental responsibility, the $39 million cannot be considered as a claim against the contractor.

3.22 National Defence has two pilot training streams. All pilots take primary flying training in the Contracted Flying Training and Support program (CFTS) and basic flying training in the NFTC program. Fighter pilots, who eventually fly the CF-18 fighter aircraft, proceed onto basic, advanced, and lead-in fighter training in the NFTC program. All other pilots proceed onto advanced CFTS training. (Exhibit 3.2) Once they complete their flying training, pilots join operational training units.

3.23 The training program has remained underused because National Defence has not enrolled enough pilots into the NFTC program. In addition, however, we found that the ability of the operational training units to absorb pilots after their NFTC training is an ongoing problem—the units do not have enough room to take in all the pilots that the NFTC program would graduate if it was used at full capacity. Therefore, the Department has been limiting the number of pilots it enrolled in the program in 2003 and 2004. This trend has continued into 2005.

Exhibit 3.2 National Defence NFTC and CFTS pilot training programs



Source: National Defence

3.24 National Defence also decided in 2004 to lower the enrolment to the NFTC basic training level as it anticipated an interruption in the next stage of training for helicopter and multi-engine aircraft pilots. The existing contract for the helicopter and multi-engine flying training expired in August 2005, and a new CFTS contract was signed in October 2005. This new contract has a two-year transition period before training can be provided at full capacity. As a result, National Defence has made a decision to under-enrol pilots in the basic NFTC program until the next stage of training is at its capacity.

3.25 The interruption in helicopter and multi-engine aircraft flying training may create more of a backlog of Canadian Forces pilots who are waiting for training and increase their wait times. We found that, since 2002, National Defence had improved wait times and backlogs. Wait times had fallen from between 18 and 22 months to about 11 months, and the backlog of pilots waiting to start flying training had dropped from about 161 pilots to about 80. However, new delays may cause backlogs and wait times to increase again.

The Department may again have more future flying training than needed

3.26 The new CFTS flying training program for helicopter and multi-engine aircraft will also offer basic flying training similar to NFTC; this may compete with the already underused NFTC program. To prevent this situation from happening, National Defence informed us that it designed the new basic flight training to be less comprehensive than the NFTC program; it is aimed at foreign nations who do not need all the training provided by the NFTC program. National Defence plans to use the new CFTS basic flying training program for its pilots only if it has a demand for it.

3.27 **Recommendation.** National Defence should take immediate action to resolve pilot enrolment limitations to ensure it makes the best use of the NATO Flying Training in Canada contract and trains the number of pilots it needs. The Department should ensure it is not creating a new basic flying training program that provides added capacity it may not use.

National Defence's response. National Defence accepts these recommendations. The Department has already taken steps to resolve pilot enrolment limitations, and it will continue working to attract sufficient pilot recruits while managing the NATO Flying Training in Canada contract to produce the required number of trained pilots. National Defence remains confident that the new basic flying training option, being developed in a complementary contract, contains measures to reduce the financial impact of fluctuations in pilot enrollment and employs the lessons learned from the NFTC project that were recommended by the Auditor General.

The request for proposals for the new flying training contract addresses concerns raised in 2002

3.28 In 2002, we recommended that National Defence ensure new contracts similar to the NATO Flying Training in Canada (NFTC) program have payments tied to performance and value received. The Department said that any of these new service contracts would incorporate performance incentives and mechanisms to pay for additional value received from the contractor. We reviewed the request for proposal for the new helicopter and multi-engine aircraft flying training contract and found that payments will be based on milestones. If the contractor fails to achieve the milestones, this could result in payment holdbacks and forfeiture. Incentives are also in place for good performance.

3.29 We also recommended in 2002 that the services purchased through a long-term contract be aligned with the Department's ability to use them. The Department responded that future service contracts would incorporate strategies and structures to account for variations in demand. Unlike with the NFTC contract, we found that the request for proposal for the new flying training contract does not limit the Department's potential foreign sales of student positions; this could allow more flexibility to sell unneeded training to other countries. The new program also has mechanisms to adjust for short-term and permanent fluctuations in training demand. These mechanisms will help National Defence better align services purchased with training requirements (Exhibit 3.3).

Exhibit 3.3 Progress on addressing our recommendation on the NATO Flying Training program in Canada

Recommendation	Progress
Auditor General's 2002 Status Report, Chapter 4	
New contracts of a similar nature to the NATO Flying Training in Canada program that the Department enters into should ensure that • payments are tied to performance and value received, and • a project management framework commensurate with the risk and design of the program is in place at the outset (paragraph 4.80).	●
The Department should ensure that the services purchased through a long-term service contract are aligned with the ability to use them (paragraph 4.81).	●
The Department should resolve the program management issues and implement a revised management framework as a matter of urgency (paragraph 4.77).	●
Lessons learned from the NATO Flying Training in Canada program should be documented and reported to senior management with an action plan (paragraph 4.79).	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Conclusion

3.30 National Defence has shown some progress in addressing the problems that we raised in 2002 concerning the NATO Flying Training in Canada program. The Department has also made progress in developing a plan to recover money owed to the Crown for training missed, which has recently resolved our main concern. Although the negotiations to reach a financial settlement took longer than the actual period in which the contractor did not meet the contract specifications, an agreement has now been reached. National Defence and Public Works and Government Services Canada need to now clarify a time frame that will ensure the Crown receives compensation in a timely manner.

3.31 The Department has not resolved pilot enrolment shortfalls and continues to incur significant losses as a result. Most of the losses are the result of under-utilization of basic flying training, which was part of the problem we found in 2002. The Department has not fully addressed problems with the pilot training process and should do so now.

3.32 We estimate that losses since the end of December 2002 amount to about $39 million and will continue to grow as the current training slowdown continues. In our 2002 audit, we raised concerns about the underuse of the NFTC contract, but National Defence assured us that the problems were temporary start-up problems and that training production would improve. In 2005, we found that training had slowed again, but for different reasons, and the financial impact has been significant. National Defence needs to take steps to make the best use of the services purchased through the NFTC contract to get the best value and use of the training it is paying for.

About the Audit

Objectives

The objective of this follow-up audit was to determine how well National Defence has progressed in its management of the NATO Flying Training in Canada program since the 2002 audit. We examined whether the Department was getting back what is owed to the Crown and if the pilot training program is meeting requirements.

Scope, approach, and criteria

The audit focussed on the management framework and processes that National Defence and Public Works and Government Services Canada have in place for the NFTC program.

We assessed the NFTC contract management from the time of the last audit, April 2002 to March 2005. This represents a three-year period in the 20-year, $3.4 billion contract. While our audit focussed on this time period, certain observations had to be linked to the pre-contract planning and initial contract phases of the program.

The 2002 audit followed up on the recommendations for procurement reform made to the Treasury Board Secretariat and Public Works and Government Services Canada in the 1999 audit on alternative service delivery. This current audit did not include the Treasury Board Secretariat's and Public Works and Government Services' progress in procurement reform.

The audit scope did not include the activities of the contractor and, as a result, the follow-up audit does not include comments on them.

The audit approach included file reviews and interviews with PWGSC and National Defence. We also met the contractor.

Quantitative information in this chapter is based on data provided by the departments. These data should be treated as unaudited.

Audit work completed

Audit work for this chapter was substantially completed on 20 January 2006.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 3. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
The cost of unused training	
3.18 Public Works and Government Services Canada and National Defence should begin action to ensure that compensation is received in a timely manner. (3.9–3.17)	Public Works and Government Services Canada and National Defence will follow up with the contractor and other relevant parties to ensure that funds due to Canada are paid promptly in accordance with the NATO Flying Training in Canada agreements. Other compensation, in the form of additional training, will be received in a timely manner based on Canada's training needs.
3.27 National Defence should take immediate action to resolve pilot enrolment limitations to ensure it makes the best use of the NATO Flying Training in Canada contract and trains the number of pilots it needs. The Department should ensure it is not creating a new basic flying training program that provides added capacity it may not use. (3.19–3.26)	National Defence accepts these recommendations. The Department has already taken steps to resolve pilot enrolment limitations, and will continue working to attract sufficient pilot recruits while managing the NATO Flying Training in Canada contract to produce the required number of trained pilots. National Defence remains confident that the new basic flying training option, being developed in a complementary contract, contains measures to reduce the financial impact of fluctuations in pilot enrollment and employs the lessons learned from the NFTC project that were recommended by the Auditor General.

Chapter

4

Canadian Firearms Program

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canadian Firearms Program

Main Points

What we examined

We examined the progress made in the management of the Canadian Firearms Program since 2002, when we reported that we were unable to complete our audit of the cost of implementing the program. We said the financial information was unreliable and did not fairly present the net costs of the program. We also reported that the Department of Justice was not giving Parliament enough information to allow for effective scrutiny of the program or to explain the dramatic increase in its costs. We made only one recommendation in 2002: The Department of Justice should rectify these gaps in financial reporting.

In our follow-up audit, we assessed the progress made by the Canada Firearms Centre in implementing our recommendation—that is, whether its recording and reporting of costs and revenues in 2004–05 presented fairly the full costs of developing, implementing, and enforcing the Canadian Firearms Program; all revenues collected by the Centre; and all refunds it issued.

We also examined the operations of the Centre as a whole since the arrival of a new management team in May 2003. We looked at whether the Centre has taken steps to ensure that the information in its database on licensing of individuals and registration of firearms is accurate and complete. We looked at its management of contracting, with a particular focus on the contracts for the Canadian Firearms Information System (CFIS)—the main data system supporting the program and a major source of its costs. And we examined the quality of information the Centre has given to Parliament on the program's performance. We did not examine the effectiveness of the Canadian Firearms Program or its social implications.

Why it's important

In 2001 the government estimated that by 2005 the Canadian Firearms Program would cost $1 billion. (The actual net cost reported by the government for the program to March 2005 was $946 million.) Since our 2002 audit, Parliament has expressed concern about the quality of information provided to it on the program's costs and performance.

Parliament's control over the public purse hinges on its voting of annual appropriations to fund departments, signalling its approval of their spending plans. Reporting of departments' expenditures accurately against their annual appropriations is thus a cornerstone of parliamentary control.

We provide a more detailed discussion of this matter in Government Decisions Limited Parliament's Control of Public Spending, tabled along with this Status Report.

What we found

- The Canada Firearms Centre has made satisfactory progress in implementing our 2002 recommendation on financial reporting, except in recording the costs of developing a new information system (CFIS II). Although the Centre correctly reported the total cumulative costs of CFIS II at 31 March 2005, in two cases significant costs were not recorded in the correct fiscal year. With the concurrence of the Treasury Board Secretariat, but contrary to the government's accounting policy and good accounting practices, the Centre understated the costs of CFIS II by $21.8 million as at 31 March 2004.
- The new management team has handled a large volume of licence applications and firearm registrations and transfers. It has dealt with operational issues such as spreading out the timing of licence renewals, expanding service in Western Canada, and consolidating the application-processing sites. It has also established the infrastructure necessary for a stand-alone department in such areas as support to the Minister's office, human resources management, and finance.
- While the new management team has made progress in addressing many of the organizational issues facing the Centre, problems remain. The Centre's performance reports contained errors in meeting service standards, which gave Parliament an incomplete picture of how well the licensing and registration activities have performed. The Centre has no formal process for following up with law enforcement on its revocations, and therefore it cannot report on their impact.
- The Centre has not assessed the quality of the data in the registration database and does not know how many of its records are incomplete. Its plans for resolving concerns about data quality hinge on a network of volunteer verifiers. We have several concerns about the operations of this network.

- Before the new management team arrived in 2003, the contracts for the Canadian Firearms Information System (CFIS) were poorly managed. As a result, the system being developed to replace it, CFIS II, is significantly over budget. Some of the increased costs are due to the fact that development began before legislation and regulations were in place. Project delays have contributed to about one third of the total cost, now expected to be at least $90 million.

The departments and agencies have responded. In general the departments have agreed with our recommendations and proposed corrective actions.

Introduction

4.1 In 1995, Parliament passed the *Firearms Act* and amendments to the *Criminal Code* to establish the Canadian Firearms Program under the principal responsibility of the Department of Justice Canada. The program is intended to reduce gun violence by

- controlling the acquisition, possession, and ownership of firearms;
- regulating certain types of firearms;
- preventing the misuse of firearms; and
- helping law enforcement agencies prevent and investigate firearm crimes and incidents.

4.2 The program involves several departments and the provincial jurisdictions for which the Canada Firearms Centre has lead responsibility. The Centre's federal partners include the RCMP, the Canada Border Services Agency, and, in lesser roles, Correctional Service Canada, the National Parole Board, the Department of Justice Canada, and others.

4.3 In 2001, the program cost $200 million annually to administer, and the government estimated that by 2005 its costs from its inception would total $1 billion. The program's actual net cost reported by the government was $946 million from 1995 to March 2005 (Exhibit 4.1). Currently, annual funding is set at $82.3 million.

Exhibit 4.1 Net costs of Canadian Firearms Program

	Expenditures				
($ million)	Past	2002–03	2003–04	2004–05	Total
Direct costs	$688.3	$78.3	$101.6	$92.8	**$961.0**
as % of total program costs	95%	85%	84%	84%	**92%**
Indirect costs	$33.6	$13.6	$19.0	$17.5	**$83.7**
as % of total program costs	5%	15%	16%	16%	**8%**
Total program costs	**$721.9**	**$91.9**	**$120.6**	**$110.3**	**$1,044.7**
Net revenues	$(55.4)	$(15.6)	$(16.4)	$(11.3)	**$(98.7)**
Net program costs	**$666.5**	**$76.3**	**$104.2**	**$99.0**	**$946.0**

What we found in 2002

4.4 In our December 2002 Report, Chapter 10, we examined the costs of implementing the Canadian Firearms Program. We stopped the audit of the program's financial information because the data was unreliable, and we reported that the Department of Justice had not fairly presented the net cost of the program. We also reported that the Department had not provided Parliament with enough information to allow for effective scrutiny of the program or to explain the dramatic increase in its costs. We made only one recommendation in 2002: The Department of Justice should rectify these gaps in financial reporting.

4.5 The Department of Justice acknowledged in our Report that implementing the program across Canada was a significant challenge. It stated that, for public safety and in response to recommendations from the public and Parliament, it had made changes to the initial program design; this had increased the design time and the cost of the program.

4.6 The Treasury Board Secretariat also noted that the Department of Justice faced significant challenges in implementing such a large and unprecedented program and stated in its response, "It was always understood that original estimates would be revised in response to the demands of program implementation."

Events since 2002

4.7 Following our audit, the government announced a number of initiatives to improve the efficiency of the Canadian Firearms Program and reduce its administrative costs:

- The Minister of Justice asked an independent consultant to review the recommendation from our 2002 audit and recommend specific actions. In February 2003, the consultant's report was tabled in Parliament.
- In February 2003, in response to the consultant's report, the Minister of Justice announced the Gun Control Program Action Plan to be implemented over the next 12 months (see Appendix A). The objectives of the action plan were to reduce program costs, improve program management, improve service to the public, and increase transparency and accountability. In the Canada Firearms Centre's *2005–06 Report on Plans and Priorities*, the Commissioner of Firearms stated that all actions had been implemented.

- In April 2003, the Canada Firearms Centre was made a separate department, reporting to the then-Solicitor General, now the Minister of Public Safety and Emergency Preparedness. In May 2003, Parliament passed Bill C-10A, amending the *Firearms Act*. This provided the basis for public and parliamentary consultations on regulatory proposals and the eventual implementation of regulatory improvements. In our opinion, this was a key action by the government because it provided for senior leadership dedicated to implementing the program and clarified financial management and reporting. Officials told us that this approach allows the Centre and other public safety agencies (in particular the RCMP and Canada Border Services Agency) to identify and co-ordinate action on firearms issues that affect public safety, including illegal cross-border movement of firearms and working with Canadian and U.S. counterparts.

- Also in May 2003, a new Commissioner of Firearms was appointed and a new management team was hired for the Centre. Senior management told us that much of its efforts have focussed on setting up the Centre as an independent department; building a capacity in such areas as policy development, human resources management, finance and administration, and ministerial support; and dealing with pressing operational issues such as consolidating processing centres, spreading out the timing of licence renewals, and improving service levels. Management's first objectives were to address the issue of reporting to Parliament and to implement a new information system. It is now looking at performance measurement and reporting.

- In October 2003, the House of Commons Standing Committee on Public Accounts tabled a report on the costs of the program, with 14 recommendations. In March 2004, the government tabled its response stating that it fully responded to the recommendations. We examined progress against all of the recommendations except those we determined were no longer appropriate given changes in conditions, such as the suspension of portions of the alternative service delivery contract. Appendix B provides a summary of the Committee's recommendations and the government's responses.

- In May 2004, the government announced measures to improve the Canadian Firearms Program, encourage compliance, and reduce the burden on firearm owners and users. The announcement followed a ministerial review of the Firearms Program, with national consultations involving stakeholders and

provincial governments. The measures included setting a spending cap of $25 million a year on **firearms registration**, streamlining the process for renewing **firearms licences**, and eliminating the fees to register and transfer firearms. These measures have been implemented.

Firearms licence—Individuals are required to have a valid licence to possess or to acquire a firearm and to acquire ammunition. Licence applicants are screened, both on the initial application and at renewal, to detect potential risks to public safety. A key element of licensing individuals is screening for continuing eligibility. This ongoing process allows the review and, if required, the revocation of an existing licence should a firearm owner become a public-safety risk.

Firearms registration—Individuals with a valid firearms licence are required to register each of their firearms according to one of three classifications: non-restricted, restricted, or prohibited. The transfer of a firearm, by sale, barter, inheritance, or gift, must be approved. A new registration certificate for the transferred firearm is issued to the new owner.

Focus of the audit

4.8 This follow-up audit assessed the progress that the government and the Canada Firearms Centre have made in implementing our 2002 recommendation—that the recording and reporting of costs and revenues in 2004–05 should fairly present the full costs of developing, implementing, and enforcing the Canadian Firearms Program; all revenues collected by the Centre; and all refunds it made. In addition, we examined operational issues that were not addressed in the first audit. In this chapter we report on the following areas:

- financial information reported to Parliament,
- measuring and reporting of performance,
- management of contracting, and
- contracting for the Canadian Firearms Information System.

We did not examine the effectiveness of the program or its social implications.

It should be noted that our conclusions about management practices and actions refer only to those of public servants. The rules and regulations we refer to are those that apply to public servants; they do not apply to contractors. We did not audit the records of the private sector contractors. Consequently, our conclusions cannot and do not pertain to any practices that contractors followed or to their performance.

4.9 More information on the objectives, scope, approach, and criteria can be found in **About the Audit.**

Observations and Recommendations

4.10 The Canada Firearms Centre has made satisfactory progress in implementing our 2002 recommendation on financial reporting, with the exception of its accounting for the costs of developing of the CFIS II, the Centre's new information system. Its methods of apportioning costs between the licensing and registration activities are

reasonable. It is now reporting the indirect costs of its federal partners in the program, although it has not developed a clear definition of what those costs include (Exhibit 4.2).

Exhibit 4.2 Progress in addressing our recommendations on financial reporting

Recommendation	Progress
Auditor General's December 2002 Report, Chapter 10, paragraph 10.89	
The Department of Justice, using a meaningful activity-based reporting framework, should annually provide Parliament in its departmental performance report complete, accurate, and up-to-date financial and management information on the following:	
• the full costs to develop, implement and enforce the Canadian Firearms Program	● except for the recording of CFIS II costs
• all revenues collected and refunds made	●
• forecast costs and revenues to the point at which the Department expects the Program to become fully operational, including details on outsourcing major components of the Canadian Firearms Registration System and moving certain headquarters functions to Edmonton	●
• complete explanations for changes in costs and revenues, and changes to the overall Program	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Financial information reported to Parliament

The Centre needs to examine how it records costs

4.11 We audited the Centre's annual expenditures of $92.8 million and its annual revenues of $11.3 million as reported in its *2004–05 Departmental Performance Report*. We found the figures to be reasonable except for an error in recording the costs of the Canadian Firearms Information System (CFIS) II. The Centre recorded an expenditure of $21.8 million in 2004–05 that it should have recorded in 2003–04. We found that this was the second of two accounting errors in the recording of CFIS development costs.

4.12 In December 2002, the Department of Justice had requested Parliament's approval for Supplementary Estimates to bring the Centre's 2002–03 planned spending to $113.5 million. Parliament at first would not approve the Supplementary Estimates as presented, but

in March 2003 it agreed to do so based on the Minister's commitment that the Centre's spending for 2002–03 would not exceed $100.2 million.

4.13 The first accounting error. The Department later reported the Centre's actual spending for 2002–03 at $78.3 million. However, this amount did not include the estimated $39 million in CFIS II development costs incurred that year.

4.14 In our opinion, in leaving the $39 million unrecorded the Department of Justice did not comply with the Treasury Board's Policy on Payables at Year-End (PAYE). This policy states that costs for large system development are to be recorded as expenditures against a departmental appropriation in the year when they are incurred, rather than when they become due and payable under a contract. Furthermore, had the Department of Justice recorded this amount in its 2002–03 expenditures, while its total spending would have remained within its **voted appropriation**, the Centre's actual spending would have been $117.3 million, $17.1 million over the limit to which the Minister had committed.

Voted appropriations—Departments are required to obtain approval of funding through annual appropriations voted by Parliament, in order that Parliament can maintain control over the public purse. Reporting their expenditures accurately against their annual appropriations is thus a cornerstone of parliamentary control.

4.15 The second accounting error. Because of the accounting issue in 2002–03 and because CFIS II costs continued to rise unexpectedly, the Centre became concerned that recording these costs would cause it to "blow its Vote." In January 2004, the Centre sought advice from the Treasury Board Secretariat on the appropriate accounting treatment for "over-expenditure." The Treasury Board Secretariat's original opinion was that all costs incurred before 31 March 2004 should be charged to the Centre's 2003–04 voted appropriation to comply with the PAYE policy. This would have meant that either the Centre would have exceeded its appropriation or required approval of additional funds through the use of Supplementary Estimates.

4.16 The Centre concluded, based on subsequent consultations with the Treasury Board Secretariat, that it would only record costs that were specifically covered by the CFIS II contract. As a result, the Centre remained within its 2003–04 appropriation level, and a balance of $21.8 million remained unrecorded.

4.17 The Treasury Board Secretariat decided to record the $21.8 million as a liability in the consolidated Accounts of Canada, rather than against the Centre's voted appropriation. The Centre reported this amount as an "unrecorded liability" in its *2003–04 Departmental Performance Report*.

4.18 Even though the Centre disclosed the unrecorded amount to Parliament, we believe the $21.8 million should have been recorded as part of the 2003–04 expenditures in order to comply with the Treasury Board PAYE policy.

4.19 The cumulative project costs of $74.3 million to 31 March 2005 were reported accurately. If the two accounting errors were corrected, however, the Centre's expenditures would be reallocated between fiscal years; its approved expenditures for 2002–03 would be shown as overspent, while its 2003–04 and 2004–05 expenditures would be within the respective appropriation levels (Exhibit 4.3).

4.20 We also note that the revised CFIS II contract as amended provides for annual payments to the contractor to operate and maintain the system over 15 years. The annual payments will also include $15 million for the costs of the remaining development work and the delay costs that the project is expected to incur in 2005–06. The Centre plans to record these costs as expenditures against annual appropriations over the 15 years, as they are paid. In our opinion, this accounting treatment does not comply with the Treasury Board's PAYE policy.

4.21 **Recommendation.** The Canada Firearms Centre should ensure that the recording of project development costs over the life of the service agreement conforms to the Treasury Board's Policy on Payables at Year-End. The Centre should record costs against annual appropriations as they are incurred.

Exhibit 4.3 Impact of correction of accounting errors ($ million)

	Costs of the Canadian Firearms Information Centre (CFIS) II			Total annual expenditures of the Canada Firearms Centre		
	As reported	Corrections made	Corrected amounts	Planned spending	Corrected expenditures	Variance over (under)
2002–03 (Justice)	$0.0	$39.0	$39.0	$100.2[1]	$117.3	$17.1
2003–04 (Centre)	39.7	(39.0) 21.8	22.5	116.0[2]	84.4	(31.6)
2004–05 (Centre)	34.6	(21.8)	12.8	99.6[2]	71.0	(28.6)
Total	**$74.3**	**$0.0**	**$74.3**			

[1] The Centre's commitment within the Department of Justice's voted appropriation

[2] The Centre's voted annual appropriation

Canada Firearms Centre's response. Payment of the remaining development costs over the life of the service agreement was one element of the restructured CFIS II contract intended to provide system delivery and service incentives to the contractor. The approach to appropriation charging was developed with the support of the Office of the Comptroller General, bearing in mind the requirements of the *Financial Administration Act* and Treasury Board policy. It will be fully disclosed in all parliamentary reporting.

Indirect costs are reported but need to be better defined

Indirect costs—Certain costs of the Canadian Firearms Program incurred by federal partners that are not reimbursed by the Centre

4.22 The Centre started to report the full cost of the Canadian Firearms Program in its *2003–04 Departmental Performance Report*, including indirect costs. Its approach was a reasonable response to our 2002 recommendation.

4.23 Our objective was to assess whether the Centre and its federal partners have adequate processes to ensure the reasonableness of indirect costs reported to Parliament. We did not audit the accuracy of these costs as reported.

4.24 Based on our review of the Centre's recent annual reports to Parliament, there has been a clear improvement in reporting the full costs of the program since our 2002 audit.

4.25 However, we found that the Centre does not have a quality review process to ensure that its partners report their indirect costs accurately and completely. Such a process would, at a minimum, include regular review of the systems and practices that partners use to report their activities that are indirectly related to firearms. Given the complexity and size of some of the partners' systems and operations, this kind of review could be a significant endeavour for the Centre.

4.26 We also found that, in some cases, the Centre and its partners have agreements under which the Centre will reimburse certain costs incurred by the partner up to a maximum amount, with any excess absorbed by the partner's operating budget. The Centre reports the costs it reimburses as "direct costs" of the program, while the excess costs that its partners absorb are reported as "indirect costs." When these agreements were adopted, the costs that constitute indirect costs of the program had not been defined. We reviewed how the indirect costs are computed and found that there is no clear definition of the cost elements that make up indirect costs.

4.27 Recommendation. The Canada Firearms Centre should define what types of cost elements should be reported as the indirect costs of the Canadian Firearms Program.

Canada Firearms Centre's response. Agreed. In conjunction with the Treasury Board Secretariat and program partners, the appropriateness and content of reporting indirect costs will be reviewed. This will be completed in conjunction with the preparation of the *2005–06 Departmental Performance Report*.

A reasonable model has been developed to allocate costs

4.28 The government has asked that Parliament start in 2005–06 to fund the Canada Firearms Centre through two votes—one for registration activities and the other for licensing activities and other operations. The government capped the vote for registration activities at $25 million per year. Because the Centre's operational units perform both licensing and registration activities, a costing model is necessary to allocate costs between the two votes. Our objective was to determine whether the Centre's costing model does this reasonably.

4.29 We reviewed and analyzed the various assumptions and estimates used in the costing model. We also performed sensitivity analyses to assess the impact that changes in key variables would have on its results. We concluded that the model can be expected to allocate costs reasonably between the two votes if it is used in a consistent way over time.

Measuring and reporting of performance

4.30 In 2002 we reported that the Department of Justice had not provided Parliament with sufficient financial information to allow it to exercise effective scrutiny and ensure accountability. Reporting performance information is a key component in accountability.

4.31 In the Gun Control Program Action Plan, the Canada Firearms Centre committed to improving its service to the public and the efficiency of the registration and licensing programs. We reviewed the levels of service established for licensing and registration and the extent to which they are met and reported, and we looked at how the Centre manages performance overall.

Reporting performance to Parliament has improved

4.32 Good-quality performance reporting is fundamental to effective governance and accountability to Parliament. At the time of our 2002 audit, we had serious concerns about the quality of financial

information provided to Parliament. In 2001–02, the Department of Justice had provided one page of performance information on the program in its performance report. It did not include information on licensing and registration by year or on how it was achieving its expected public safety results. At the time of this follow-up audit, the Canada Firearms Centre had tabled its performance reports for 2003–04 and 2004–05; these reports provided significantly increased performance information on the program.

4.33 To determine the quality of these reports, we used our Office's model for rating performance reports. Our model is generally consistent with performance reporting principles in Treasury Board Secretariat guidelines. Our April 2005 Report, Chapter 5, describes how the model is used to rate performance reports. In that chapter we noted that providing quality performance reports to Parliament continues to be a challenge for many departments, even after almost a decade of effort.

4.34 The Centre's performance reports provide a fair to good overview of its organizational context and planned strategic outcomes. The reports could be improved with a description of

- the risks it faces to achieving its planned strategic outcomes, and
- the challenges it faces in contributing to government-wide initiatives while achieving its own expected outcomes.

4.35 We found that the Centre reported performance at a basic level in the more important and difficult areas—namely,

- stating performance targets,
- reporting results, and
- reporting how results will be used to improve future performance.

4.36 In particular, the Centre has not set any performance targets and has provided few examples of its outcomes. Instead of reporting the key results achieved, the Centre describes its activities and services.

4.37 We noted that in its 2003–04 report, the Centre estimated that almost 90 percent of all firearm owners had complied with the licensing regulations. However, it did not provide a corresponding estimate in its 2004–05 report. The Centre told us that it had been concerned because the estimate of compliance was based on information that was becoming outdated. In our opinion, it is important that the Centre either tell Parliament the level of compliance with the legislation or explain the difficulty of estimating it.

4.38 The Centre's strategic outcome is to ensure that "the risks to public safety from firearms in Canada and international communities are minimized." The performance report focusses on activities such as issuing licences and registering firearms. The Centre does not show how these activities help minimize risks to public safety with evidence-based outcomes such as reduced deaths, injuries, and threats from firearms.

4.39 The Centre has said that there are many statistical and data problems in linking its licensing and registration activities to public safety outcomes. A recent government evaluation of the Canadian Firearms Program stated that it will not be possible to determine the outcomes of the program until it has been operating longer.

4.40 While the Centre may not be able to show direct evidence of how its activities contribute to its public safety goals, it could improve its performance reporting by using a results chain. A results chain can help an organization

- show its contribution to a planned outcome,
- link its performance expectations to key results, and
- attribute outcomes shared by its partners and other levels of government.

4.41 **Recommendation.** The Canada Firearms Centre should improve its reporting on the performance of the Canadian Firearms Program by providing targets and evidence-based results, and by showing through the use of a results chain how these results could contribute to public safety goals.

Canada Firearms Centre's response. Agreed. As a new department the Centre's priority has been to ensure that the program's fundamental baseline data is correct and to develop the capacity for more in-depth analysis of performance information. As the chapter notes, this has resulted in a significant increase in the performance information provided to Parliament. The Centre will continue to enhance its performance reporting as the program matures and more complete longitudinal data becomes available.

The Centre has not consistently stated what its client service standards are or how it measures performance

4.42 The government's action plan for the Canadian Firearms Program, announced in February 2003, included initiatives to improve the management of the program and service to the public. These actions were to be implemented within 12 months.

4.43 **Initiatives to improve management.** We found that almost three years later, some of these performance management initiatives have not been fully implemented—for example, the action plan committed to "establishing national work performance measurements and cost standards." We found that the performance measures that were established are not being used, and staff told us that these measures are irrelevant to operations. We also noted that the Centre has not established cost standards.

4.44 In March 2004, the Miramichi and Québec processing sites were consolidated. The Centre stated in its performance report that this would reduce costs and maintain the quality of service. Cost savings were estimated at $2 million annually. The Centre has not reported the outcome of the consolidation.

4.45 **Initiatives to improve service to the public.** To enhance service to the public, the government committed to "ensuring clients can easily access 1-800 telephone information services." The Centre has not established service standards for easy access. It reported to Parliament that the response time for calls to its national call centre "averaged just over two minutes." The Centre was unable to tell us the actual number of calls that were answered in just over two minutes. We found that while average wait times increased in 2003–04, they decreased in 2004–05. In our opinion, it would be more useful to know how many actual calls met the standard.

4.46 The government also committed to "processing properly completed registration applications within 30 days of receipt." It later developed a similar service standard for processing licence applications within 45 days of receipt. In its first performance report, in 2003–04, the Centre said it had met both these service standards. However, it could not provide us with the original calculations showing how it determined that it had met its standards.

4.47 Officials told us that in calculating performance for the two service standards, they did not include applications that had client eligibility failures (applications with issues to be investigated), even if the application had been properly completed. Investigations to

determine eligibility can add days or weeks to the processing time, and the Centre has not established service standards for applications that involve such investigations. Applications with eligibility failures accounted for 46 percent of licence applications from August 2004 to August 2005.

4.48 We examined the processing times for properly completed registration and licence applications in 2003–04. We found that 45 percent of registration applications had taken longer than 30 days to process and 35 percent of licence applications had taken longer than 45 days. We concluded that the Centre had not met its service standards, as it had stated in its performance report.

4.49 In its performance report for 2004–05, the Centre reported that 89 percent of registration applications had been processed within 30 days and 86 percent of licence applications within 45 days. We analyzed the data and found that only 73 percent of registration applications met the 30-day standard, not 89 percent.

4.50 We noted that in its 2004–05 performance report, the Centre reported that it was defining new performance standards over the next 12 months and reviewing existing standards.

4.51 Recommendation. The Canada Firearms Centre should present its performance information in its performance reports in a comprehensive and complete manner that allows Parliament to fully understand the performance it has achieved and the challenges it faces.

Canada Firearms Centre's response. Agreed. As acknowledged by the Office of the Auditor General, there has been a significant increase in performance information provided to Parliament. Having established this foundation, the Centre will continue to enhance its performance reporting as the program matures and more complete longitudinal data becomes available.

4.52 Recommendation. To improve its service to the public, the Canada Firearms Centre should analyze how long it takes to investigate and complete licence and registration applications that have client eligibility failures, identify the nature of the problems, and take appropriate action.

Canada Firearms Centre's response. Agreed. As identified in the Centre's *2004–05 Departmental Performance Report*, client service standards are being reviewed. This review will take into consideration lessons learned during the audit, including the impact of the

investigation of eligibility issues on meeting service standards. This will be done recognizing that a balance must be struck between the efficiency with which client applications are processed and the effectiveness of the investigation procedures related to public safety.

Data quality needs to be addressed

4.53 In his 2003 Report, the Commissioner of Firearms acknowledged "the need for the highest possible quality of information in the Canadian Firearms Information System to support law enforcement and reduce risks to public safety." The Canadian Firearms Information System (CFIS) is a national database of information on licences issued and firearms registered. The Centre has told us that addressing the quality of data in the CFIS is a priority.

4.54 Our objective was to determine the extent to which the Centre has taken steps to ensure the accuracy of licensing and registration data in the CFIS. We expected the Centre to have systems in place to estimate the quality of data and to establish targets for quality.

4.55 Following our 2002 audit, the Centre took steps to improve the quality of data—for example, by adding a feature that allows applicants to change their address on-line and by verifying information received over the telephone. However, the Centre told us that it does not validate its information against other federal or provincial databases but it plans to explore options as part of the new information system, CFIS II. For example, we noted that rates of undeliverable mail ranged from seven percent of licence renewal notifications to 23 percent of firearm registration revocation notices.

4.56 In November 2004, the Centre published a plan to address over 130 issues that affect the quality of data, for example,

- potential duplicate registration certificates, and
- errors in owner's name, date of birth, or current residential address.

4.57 We noted that the Centre's plan did not establish targets for data accuracy or methods of measuring the accuracy of data in the CFIS. Centre officials told us that they are making significant progress in resolving the issues identified in the plan.

4.58 Before the *Firearms Act* was passed in 1995, about 1.2 million prohibited and restricted firearms were registered in the Restricted Weapons Registration System (RWRS). The Act required these firearms to be registered again in the new Canadian Firearms

Information System by 1 January 2003. About half of the 1.2 million firearms registered in RWRS still have not been re-registered with the Centre, but RWRS remains operational so information on those firearms is still available.

4.59 A 1994 study commissioned by the Department of Justice found that, in the RWRS, many of the records for restricted and prohibited firearms were outdated or incorrect. However, owners who had registered in the CFIS were not required to confirm or update information provided previously. Confirmation of information would have strengthened the quality of data in the CFIS.

4.60 In 2002 we reported that to reduce the burden of the Canadian Firearms Program's requirements and to increase registration, the government had approved a more flexible standard for describing firearms. As a result, the Centre relied on applicants to describe their firearms with reasonable accuracy. It did not physically verify descriptions provided by applicants at the time of registration, and the registration process did not require information such as model or exact barrel length. The Centre expected to correct and complete firearm records at the time that the firearm is transferred.

4.61 As an indication of the scope of the data quality problem, we found that as of October 2004, 27 percent of all registered firearms had been verified. After 24 October 2004, almost 142,000 previously registered firearms were transferred to different owners and verified for the first time. In that **verification** process, the description of some firearms were changed. Accurate firearms descriptions are critical information for identification purposes and are important to the Canadian Firearms Registry's support of law enforcement. For instance,

Verification—A process used to confirm the physical details such as manufacturer, model, serial number, barrel length, and type of action of a particular firearm.

- nine percent of registration certificates needed to have information on a firearm's action corrected from, for example, bolt action to semi-automatic;
- twelve percent needed to have the firearm's make corrected; and
- three percent needed to have the serial number corrected.

However, we noted that only 0.1 percent of firearms classifications (unrestricted, restricted, or prohibited) had to be changed. This classification is the key element for the type of licence required by a gun owner.

4.62 We also attempted to determine whether all transferred firearms had undergone the required verification. Due to problems in accessing

the data, we were unable to conclude whether they had. We are concerned that the Centre cannot easily retrieve such information to use in managing its activities.

4.63 At the time of initial registration, the Centre had an opportunity to create a complete and accurate firearms registry. Due to the decision to encourage registration and reduce the workload by accepting incomplete information before the legal deadline of 31 December 2002, the Registry continues to suffer from data quality problems. Given the current status of the Verifiers Network and the degree to which verification is done by phone, the Centre is missing another opportunity to strengthen the integrity of Registry data.

4.64 Recommendation. The Canada Firearms Centre should ensure that its new information system will be able to provide management with the performance information it needs to run the Canadian Firearms Registry.

Canada Firearms Centre's response. Agreed. The project is being assessed to ensure that the system provides appropriate operational and management information in support of all aspects of the program.

4.65 Recommendation. As part of CFIS II, the Canada Firearms Centre should validate addresses against information in other databases, and check all records for entry errors and completeness.

Canada Firearms Centre's response. Agreed. As noted in the chapter, the Centre has an ongoing plan to monitor and address data quality issues. This initiative will continue to form part of the ongoing continuous improvement plan. Specifically, the Centre will

- explore cost-effective alternatives to validate address information with other databases,
- examine a solution to migrate Restricted Weapons Registration System information, and
- continue the process of validating data accuracy and completeness.

Weaknesses exist in the Verifiers Network

4.66 To address the issue of data quality, the Centre expected to verify previously registered but unverified firearms at the time of a transfer, using a network of volunteer verifiers. These verifiers are important to correcting any errors in the data of the CFIS. However, from early 2002 to summer 2003, officials of the Centre confirmed that it did not have contact with its volunteer verifiers.

Verifier—The Canada Firearms Centre (CAFC) has established a Verifiers Network to assist businesses and individuals that need to have their firearms verified. The service is provided at no charge by a community volunteer, such as a firearms dealer, gun club member, or safety instructor. A verifier must sign and date the application to indicate that the firearms on the list have been verified.

4.67 Because some registrants have difficulty getting to a verifier, the Centre also provides the service over the telephone. According to the Centre, 20 percent of transfers and new registrations have been verified by telephone since October 2004. Police organizations and gun-control advocates have stated that inspecting every firearm registered is important to ensuring the integrity of the system. The Centre does not have guidelines on when to conduct a telephone verification, and it has not studied whether the quality of registry data is affected by telephone verification.

4.68 In its *2004–2005 Report on Plans and Priorities,* the Centre announced plans to improve its network of volunteer verifiers in order to ensure that gun owners have access to an approved verifier. Recent activities have included the following:

- **Improving contact with verifiers.** The Centre has been improving its contact with verifiers by sending out regular bulletins and adding a Verifiers Network section to its Web site. In September 2005, it held cross-country consultations with about 120 verifiers to discuss how the network could be improved. Officials told us additional work is planned.
- **Determining the number and location of verifiers.** In August 2005, the Centre completed a project to map the location of about 3,000 verifiers who are willing to perform verification for the public.

4.69 We noted the following weaknesses in the Verifiers Network:

- **No performance or service standards.** There are no performance or service standards for verifiers, such as timeliness of service or distance travelled to verify firearms. We also noted that the Centre does not know how many verifiers are needed and where they are needed to meet the demand for verification services.
- **Verifiers can verify their own firearms.** In our opinion, allowing volunteers to verify their own firearms creates a potential conflict of interest.
- **Lack of evaluation of verifiers**. To become a verifier, a person must have a valid firearms licence and attend a three-hour training session. There is no qualifying or post-training test and no background checks beyond those that are part of the licensing process.
- **Lack of quality assurance**. There is no quality assurance system in place to check a verifier's work.

4.70 **Recommendation.** The Canada Firearms Centre should undertake a complete review of the volunteer Verifiers Network, including determining how many verifiers are needed, where they are needed, and how they should be managed.

Canada Firearms Centre's response. Agreed. As identified in the Department's *2005–06 Report on Plans and Priorities*, the development and implementation of a strategy to enhance the firearms verification process was identified as a priority. In the fall 2005, surveys were sent to 3,328 verifiers and 952 firearms owners. These surveys, in addition to the consultations with verifiers, resulted in an approach to identifying the number of verifiers needed. Additional analysis will be completed over the coming months and the resulting strategy will be implemented during 2006–07.

The Centre has limited ways to follow up on revocations of firearm registration certificates

4.71 Between July and October 2005, the Centre revoked 2,653 firearm registration certificates of 1,254 licence holders because of expired licences. If a licence expires or is revoked, a person is no longer legally permitted to own a firearm. When firearm owners receive a revocation notice, they are required to apply for a new licence, transfer the firearm, or dispose of the firearm by deactivating it or turning it in to the police.

4.72 The Centre does not know the status of 62 percent of the firearms that had their registration certificates revoked between July and October 2005. Its only recourse is to contact the local police by letter and then by telephone, because it lacks a mandate to enforce revocations. The Centre told us that it is the role of the police to seize revoked guns. However, police are not required to notify the Centre when they destroy a firearm, enforce revocations, or seize firearms. In September 2005, the government delayed implementing regulations that would require local police to notify the Centre within 30 days of taking any firearms into protective custody.

4.73 **Recommendation.** The Canada Firearms Centre should take the necessary steps to follow up on revocation orders, including seeking the implementation of the Public Agents Firearms Regulations.

Canada Firearms Centre's response. Agreed. In conjunction with the implementation of the Public Agents Firearms Regulations, the Centre will review its processes regarding follow-up on revoked registration certificates.

Management of contracting

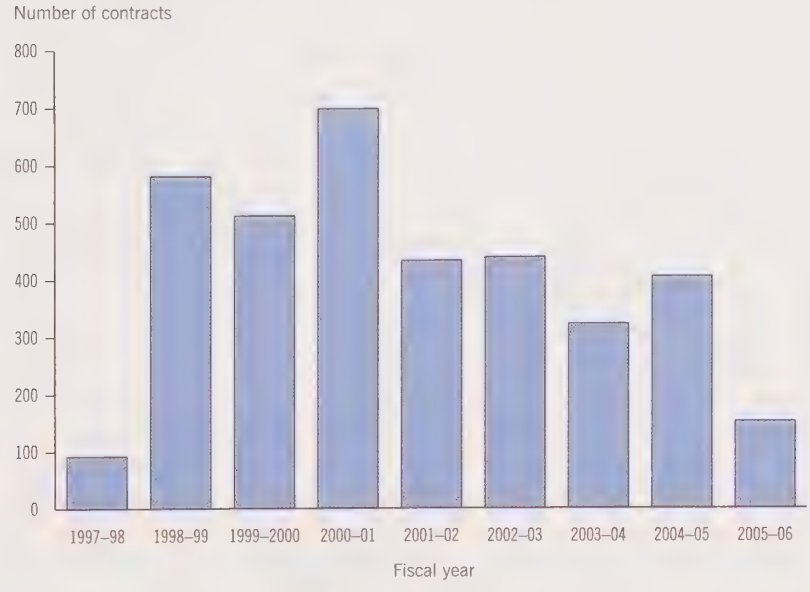
The Centre is improving its contracting practices

4.74 The Canada Firearms Centre delivers many of its services through contracts. Therefore, non-compliance with contracting regulations and authorities represents a significant risk for the Centre. We had planned to look only at contracts signed since 2002, but found that the Centre still depends on contracts initiated years earlier by the Department of Justice or by Public Works and Government Services Canada. We therefore assessed all 3,642 contracts from January 1997 to June 2005 to determine whether

- contracting was managed adequately and with due regard to economy,
- officials complied with the Treasury Board policy on contracting and with the Centre's contracting authority, and
- contracts were awarded competitively or had proper justification on file for sole sourcing.

4.75 Program managers sign 400 to 500 contracts per year on average (Exhibit 4.4); 2000–01 was the most active year, with 700 contracts signed.

Exhibit 4.4 Number of contracts awarded each year by the Canada Firearms Centre



4.76 While the number of contracts is large, more than 68 percent of their combined value is accounted for by two contracts for developing the Canadian Firearms Information System I and II. We discuss these two contracts separately.

4.77 In selecting a sample of contracts to review, we analyzed all 3,642 contracts for "red flags" that might indicate non-compliance with regulations, for example,

- a final contract amount more than 150 percent of the original amount, which could indicate a failure to seek competitive bids or an attempt to evade contracting limits;
- multiple low-dollar-value contracts to one supplier, which might indicate contract splitting; or
- other evidence that contracts may not have been awarded competitively, such as multiple contracts with the same date.

4.78 Based on our analysis, we identified three activities that indicated a high risk of non-compliance with regulations, which could also affect fairness and best price:

- sole-source contracts
- large amendments to contracts
- multiple contracts to the same vendor

4.79 We had specific criteria that a contract had to meet before we would look at it in detail. The use of specific criteria to select our sample of contracts meant that those selected had a high probability of non-compliance. These results cannot be applied to the entire population of 3,642 contracts. We identified 485 contracts that had at least one red flag, and from those 485, we selected a **purposeful sample** of 147 contracts for detailed audit.

Purposeful sample—A sample selected not at random but to provide insight and in depth understanding rather than generalizations about the whole population

4.80 In our sample, we found contracts that were awarded without a proper competitive process, for example,

- contracts below $25,000 (the limit for sole sourcing) that were amended to 150 percent of the initial value,
- multiple contracts for $24,000 issued to the same vendor on a continuous basis,
- contracts awarded using a request for proposals and subsequently amended to much higher amounts,

- multiple contracts issued to the same vendor on the same day using a standing offer, and
- contracts issued on a sole-source basis without proper justification.

4.81 In the federal government, while departments have authority to handle contracts up to a certain dollar amount, Public Works and Government Services Canada (PWGSC) contracts on behalf of other departments for many goods and services. PWGSC also has in place contracting tools that, when used correctly, allow departments to meet competitive procurement requirements by selecting contractors from a list to submit bids. Officials at PWGSC told us that when a department uses those tools, the department becomes the contracting authority and is ultimately accountable. However, PWGSC is responsible for ensuring that the tools are used in accordance with prescribed policies and regulations.

4.82 We found that the Centre misused contracting tools to retain the services of information technology (IT) contractors. We looked in detail at 13 contractors who had been with the Centre for several years—the longest period was from January 1997 to June 2005. We found evidence that there were also five other contractors who had been with the Centre for several years.

4.83 In most cases, these contractors were hired using one of two PWGSC contracting tools:

- **The Informatics Professional Services (IPS) Marketplace.** IPS is a procurement database, managed by PWGSC, that allows federal departments to search for consultants based on a list of skills and experience. IPS produces a list of qualified consultants, and departments are supposed to select at least three contractors and invite each to compete. Departments were allowed to go up to the limit of the North American Free Trade Agreement ($89,000 per contract) only once using IPS. Additional requirements for a consultant need to be met through competitive means.

  We examined 15 cases, from 1997 to 2004, where the contractor was retained for many years using IPS. Searches of the database would yield only the name of the incumbent contractor. The result was that contracts were awarded directly to a consultant, using IPS to justify a non-competitive procurement process. In our opinion, this was a misuse of the IPS tool that made directed contracts appear to have been awarded competitively. We found

that the Centre was the contracting authority in most of the 15 cases.

The Centre told us it recognizes that IPS was used inappropriately, and it ceased the practice in 2004.

- **The Information Technology Services Branch (ITSB).** This branch of PWGSC provides IT professional services to departments through three master contracts it has with IT consulting firms. These contracts were awarded through a competitive procurement process. Client departments request professional services from ITSB through a service agreement.

  We found that in 11 cases, incumbent contractors who had been at the Centre for several years remained there from 2004 to 2005 under ITSB supply arrangements. We found evidence that the Centre asked ITSB to provide its list of incumbent contractors to the IT consulting firm under contract with ITSB, with the intention of continuing their services. PWGSC officials said that they agreed to this practice because the Centre told them that it needed the incumbents in order to meet operational requirements. We also found documents showing that PWGSC staff assured the Centre that it was procuring professional services legitimately. In our opinion, because the individual task authorizations were used to direct business to specified contractors, the end result was a non-competitive process and did not meet the objectives of the Treasury Board Contracting Policy. They also lacked due regard to economy—for each incumbent, the Centre paid ITSB, who paid the IT consulting firm, who, in many cases, paid the sub-contractor, who finally paid the incumbent. Using ITSB added two additional commissions to the cost of a consultant. We noted that on average the cost to the Centre for each consultant increased by about 25 percent under this supply arrangement.

4.84 In the case of the 13 contractors retained over several years, we are concerned about a potential liability to the government because the Centre may have established an employer–employee relationship. We were told by staff that these contractors have been kept for the transfer from the Canadian Firearms Information System (CFIS) I to CFIS II—an event that they had anticipated would happen a few months after March 2003. We were also told that the contractors were indispensable to the smooth operation of the CFIS and, in some cases, possessed unique knowledge. However, we question this argument because one of the contractors has already been replaced successfully,

and ITSB has informed us that it will not be renewing the current supply arrangement with the Centre.

4.85 We also found specific cases in our sample of 147 contracts that did not follow good contracting practices.

- A contract from 1 January 1997 to March 2000 retained a consultant as senior Project Manager for CFIS I; the title of the position was subsequently changed to Project Director. The position had full signing authority, including authority to contract for consultants. The justification for sole-source procurement was that the consultant had been doing the same work at the Department of Justice. The initial contract was for $151,261.40; the final total, with amendments and new contracts, was $700,253.29. PWGSC was the contracting authority for this contract.
- A contract originally for $135,000 in 1998 used a request for proposal process. Subsequently, only the incumbent submitted a proposal. The file shows that the incumbent was rated on work done in the position, rather than on the requested proposal. We also found an amendment that predated the contract. In this case, PWGSC was the contracting authority.
- A contract in 2001 was signed after the work period had passed. In this case, the Centre was the contracting authority.
- Several fixed-price contracts were awarded to three contractors in 2001 and 2002 that, in some cases, had no measurable deliverable, and no record of a deliverable product being received. The initial value of each contract was below the $25,000 limit, but the final values were much higher: $50,000, $107,000, and $319,431. We noted that requests for the contractors' security clearance stated that they would have no access to the work site. In these cases, the Centre was the contracting authority. We will be reviewing these contracts in greater detail.

4.86 We found that the number of red flags has decreased significantly since 2004 as the Centre improves its contracting practices. Exhibit 4.5 shows that the number of contracts awarded between $24,000 and $25,000 has dropped since 2000–01. Exhibit 4.6 shows that the number of contracts below $25,000 that were amended in excess of 150 percent has dropped since 2000–01.

4.87 The Centre has a new contracting manual in place. It is also conducting an internal audit of its contracting practices that it was planning to report on in the winter of 2006. However, we still have

concerns, having found that the Centre is continuing to contract IT consultants through PWGSC without a proper competitive process. We also noted cases of sole-source procurement for professional services in areas other than IT.

Exhibit 4.5 The number of contracts between $24,000 and $25,000 has dropped significantly since 2000–01

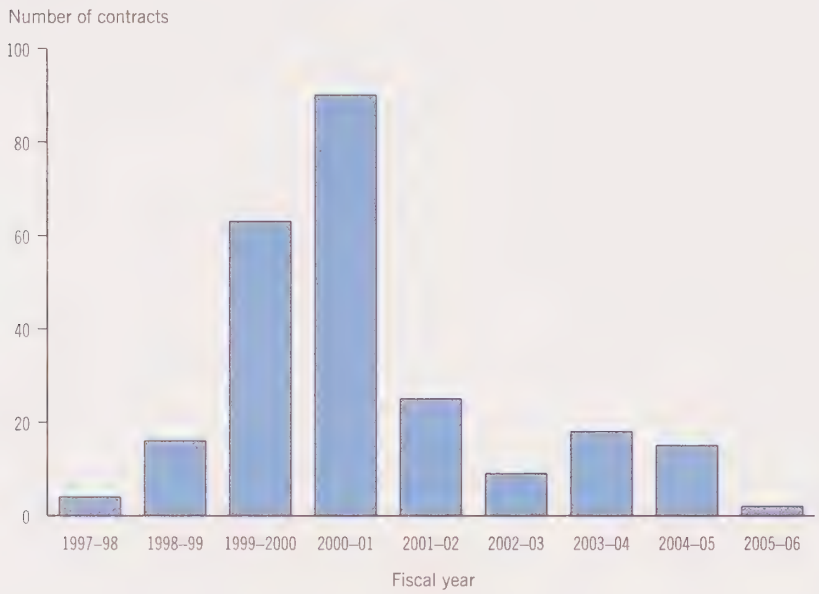
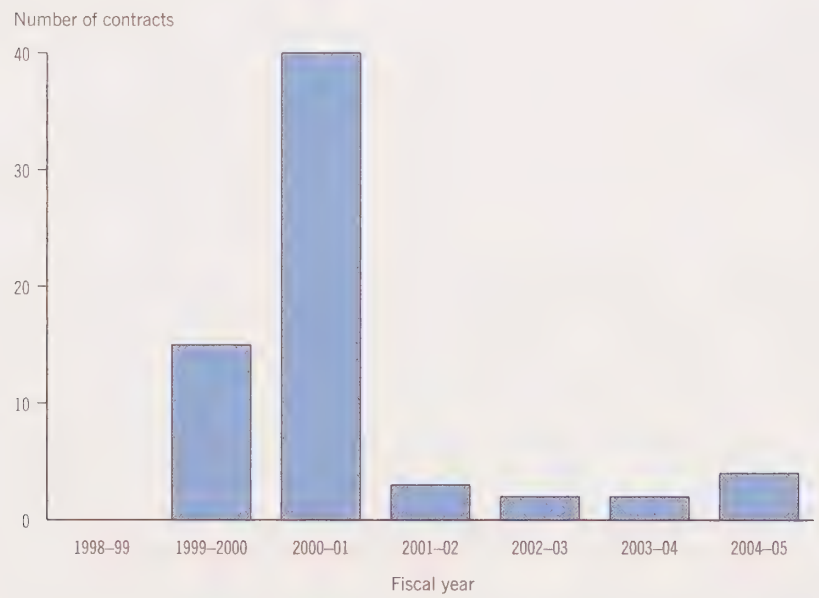


Exhibit 4.6 The number of contracts below $25,000 that were amended by more than 150 percent has dropped significantly since 2000–01



4.88 Recommendation. Public Works and Government Services Canada should review how client departments use the contracting tools it has developed. It should be able to provide assurance that its tools are not being used to circumvent contracting policies and regulations.

Public Works and Government Services Canada response. The Auditor General's recommendation identifies a weakness with the proper use of the Department's contracting tools. The Department recognizes the importance of this recommendation and is taking corrective measures to address the issues highlighted in this chapter. Such measures include training of users on accountabilities, policies, and processes, increased monitoring and reporting of usage; and, where appropriate, restricting use of the tool.

4.89 Recommendation. The Canada Firearms Centre should review its contracting of IT consultants to ensure that it does not create employee-employer relationships.

Canada Firearms Centre's response. Agreed. The Centre continues to take steps to reduce its dependence on the core group of IT consultants. As contracts of the Information Technology Services Branch of Public Works and Government Services Canada come up for renewal, they will not be extended. Additionally, the Centre has contracted the provision of IT services to a private sector service provider. As a result, the contractual relationship with the individuals in question will cease.

Contracting for the Canadian Firearms Information System

4.90 In 2002 we reported the following problems with the CFIS I, then known as the Canadian Firearms Registration System.

- The scope of CFIS I had expanded well beyond the Department of Justice's experience. Internal audits by the Department had revealed several major project management problems, including not establishing a formal framework for financial reporting until the project was well under way and making a high number of changes in the design of the system.
- In 2001, the Department of Justice told the government that the three-year-old CFIS was not working well. The system had been developed at the same time as changes were being made to the forms, rules, and processes for the Canadian Firearms Program and before legislation and regulations were finalized. The Department stated that the complexity of CFIS increased unnecessarily because many of the design assumptions were invalid.

- The government approved outsourcing the redesign of the existing CFIS as part of its restructuring of the program.

4.91 We examined the development of CFIS II to identify the factors that had led to the increase in total costs. We expected to see lessons learned from CFIS I applied to the establishment and management of CFIS II. We also looked for evidence that the Centre had followed the Treasury Board policy (including the Enhanced Management Framework) for managing large IT acquisitions.

4.92 Exhibit 4.7 presents the CFIS I story through a timeline of significant events, and Exhibit 4.3 outlines the costs of CFIS II.

The lessons learned from CFIS I were not used in developing CFIS II

4.93 Consistent with internal audit reports issued by the Department of Justice and the Centre, we found that CFIS I took longer to implement than expected and cost more than twice the original estimate because of the following factors:

- change control processes were poorly managed by the Department of Justice,
- project requirements were not well defined,
- a level-of-effort (cost plus) contract was used, and
- the passage of Bill C-10 and its regulations was delayed for more than two years.

4.94 Estimates of final costs varied over time, as well as what was included in calculating them. In 1995 the Department of Justice said, in the financial framework for Bill C-68, that costs associated with the development of CFIS I would reach $48.8 million for the Department of Justice alone, and that total costs would be $85 million by 2000. The Effective Project Approval in 1998 estimated total development costs at $94.5 million. We found that at 22 March 2005, total CFIS I project costs, which included development, maintenance, and operations, were almost $190 million.

The decision to proceed with CFIS II was ill-considered

4.95 In 2001 the Department of Justice supported redeveloping CFIS I, despite pending regulatory and legislative changes that represented major risks to the project. These risks were identified in a draft consultant's report and draft internal reports. The Centre's current management was unable to provide us with final versions of these reports, to confirm who had seen them, or to provide a plan

Exhibit 4.7 Canadian Firearms Information System (CFIS) I and II development timeline

Year	Canadian Firearms Information System I	Legislative and regulatory environment	Canadian Firearms Information System II	Management environment
1995		*Firearms Act* receives royal assent but proclamation delayed to January 1997 to develop information system (December).		Firearms Control Task Group within Department of Justice manages the Firearms Control Program.
1996	Request for proposal to select system developers (mid-year).	*Firearms Act* regulations tabled but not passed (November).		Canadian Firearms Centre (CAFC), within the Department of Justice, is designated to implement Canadian Firearms Program (1996).
1997	Contracts signed with CFIS I system developers (November).	Revised regulations tabled but not passed (October).		
1998	Treasury Board gives effective project approval for CFIS I (May). CFIS I is partially implemented (December).	Revised regulations passed (March). *Firearms Act* and regulations come into effect (December).		
1999	Performance working group established to review CFIS I performance (January). CFIS I is fully implemented; systems performance problems are identified (May).			
2000	Consultant study warns planned changes to CFIS I would be a major risk (May).			Chief Executive Officer appointed for the Centre (January 2000 to July 2001).
2001		*Firearms Act* amendments tabled. These amendments will affect information system requirements (March).	Department of Justice tells government CFIS I needs restructuring (2001). Treasury Board approves restructuring plan (March).	New Chief Executive Officer appointed (July 2001 to January 2003).
2002	CFIS I costs and levels of performance stabilize.	Legislative amendments die when Parliament adjourns (June). Revised legislative amendments tabled (October).	Treasury Board approves further system development (May). Contract awarded to system developers (July).	Auditor General's Report: Department of Justice—Costs of Implementing the Canadian Firearms Program (December 2002).
2003		Legislative amendments to the *Firearms Act* receives royal assent (May). Regulatory changes tabled (June). Regulatory changes on hold pending ministerial review of program (December).	Ready to implement (March). Implementation delayed (March). Delay costs are incurred (April). Implementation put on hold until regulations are passed (November). Treasury Board designates CFIS II as a Major Crown Project (November).	Gun Control Action Plan (February). New Chief Executive Officer appointed (February). CAFC becomes a separate department reporting to the then Solicitor General, now the Minister of Public Safety. Current Chief Executive Officer is appointed as Commissioner of Firearms (May).
2004		Regulatory changes passed (December).	Information System developers' contract extended (March).	
2005	New release of CFIS I to meet regulatory changes (April).	Regulatory changes come into effect (April).	Treasury Board directs CAFC to report on CFIS II progress (February).	

showing how the risks would be mitigated. In addition, the draft reports identified major risks due to higher expectations for the system's capabilities than the budget could support and a timeline that was too short to complete the project.

4.96 The draft reports were all similar and predicted with high accuracy the major risks to the CFIS II project. The project is already more than two years late, and the estimated cost is now about $90 million. At the end of our audit, the expected completion date was spring 2006.

4.97 We found that the request for proposals for CFIS II that went out in the fall of 2001 did not include detailed requirements. The contractor that won the bid did not receive the user specifications until after receiving the letter of intent stating that it was the successful bidder. The Centre told us that management chose this approach to encourage the creativity of the proposals. The letter of intent also told the contractor to start work before the formal contract was signed. The contractor was later able to claim that changes in the project's scope had resulted in additional costs.

4.98 In our opinion, the CFIS II cost overruns resulted from the decision by senior managers in 2001 to build CFIS II before CFIS I was fully stable and operational and before the legislative and regulatory changes had been completed. We also found that the applicable lessons learned from CFIS I were not applied in the development and management of CFIS II.

CFIS II project delays contributed to significant escalation of project costs

4.99 Although it was originally planned that the CFIS II development phase initiated in April 2002 would take nine months, after three years it is still under way.

4.100 There were significant delays during the development phase, for reasons that include the following:

- Although originally planned for January 2003, Bill C-10A to amend the *Firearms Act* did not receive royal assent until May 2003, and related regulations were not enacted until December 2004.
- The approved legislative amendments resulted in significantly more changes to the system requirements and to the scope of the project than had originally been communicated to the contractor.

4.101 In March 2003, the contractor completed the development of the system based on the original requirements. However, because the legislative process was still ongoing and the Centre expected that the system as developed would not meet the new requirements, it put the project development on hold. As a result, the Centre incurred delay costs of $30.6 million during 2003–04 and 2004–05. Delay costs included

- the costs to the contractor for retaining the personnel to complete the system;
- the costs of maintaining the system while the project was on hold, for example, the cost of purchased computer equipment and monthly charges for software licences; and
- interest charges of $2 million due to project delays and a delayed-payment schedule negotiated by the Centre in the original contract.

4.102 Under the restructured agreement with the contractor, the Centre capped the development and delay costs required to bring CFIS II into service at $15 million, to be paid over 15 years. The negotiated 15-year payment plan will result in a total cost of $23 million, with $8 million of that amount as interest charges. In our opinion, this does not represent due regard to economy.

4.103 The Centre's management told us that one of its objectives for the restructured agreement was to transfer some of the project risk back to the contractor, by

- setting a cap on the costs of completing the system and on service delivery costs over 15 years, and
- eliminating a price **escalator clause** and a clause to reprice every five years, which had been in the original agreement.

Escalator clause—A statement in a contract that provides for increasing one amount in proportion to a change in another amount.

4.104 With the restructured agreement, the Centre intended to stop the accumulation of delay costs, defer the outsourcing of the Central Processing Site until the Centre's operations had stabilized, and ensure that no further payments would be due to the contractor until the system described in the agreement was implemented.

A project management plan for CFIS II is being put in place

4.105 We reviewed the management of the CFIS II project and found that appropriate management practices for a project of such cost and complexity are now being put in place. In June 2003, the Treasury Board directed that the alternative service delivery plan that was the

basis for the CFIS II contract be reviewed by the Centre in the context of a major Crown project. In November 2003, the Treasury Board designated the CFIS II as a major Crown project and directed the Centre to provide a detailed project submission prior to January 2004 to reflect the new designation. Officials at the Centre told us that because of uncertainty at that time over the future direction of the Canadian Firearms Program, they had reassessed whether to continue with CFIS II, and no development work occurred during this period. No project submission was prepared. As a result of the uncertain status from November 2003 to February 2005, the CFIS II project was not reported as a major Crown project, although it had been designated as one.

4.106 In February 2005, the Treasury Board directed the Centre to report on the project's progress in its report on plans and priorities and its performance report. This reporting will replace the major Crown project policy requirement for progress reports to the Treasury Board. The Centre plans to submit a project evaluation and a close-out report before the end of 2006–07.

4.107 The Centre has developed a project management plan that includes creating an organizational structure and hiring new project management staff for CFIS II's completion. The staffing and structure represent progress; however, a formal, integrated project management plan that defines clear roles and responsibilities is still required.

4.108 Recommendation. The Canada Firearms Centre should clarify for Parliament the current status of the CFIS II system development phase. It should also clearly identify the nature of the services it is to receive during the operational 15-year period and reconcile their cost with the service charges in the original contract from 2002.

Canada Firearms Centre's response. Agreed. The Centre will continue to provide Parliament with improved CFIS II reporting, including information on the system development project and the nature of services to be provided over the 15-year operation period.

Conclusion

4.109 The Canada Firearms Centre has made satisfactory progress in implementing our 2002 recommendation on financial reporting, except in its accounting for the costs of developing the CFIS II, its new information system. Its methods of apportioning costs between the licensing and registration activities are reasonable. And it is now

reporting the indirect costs of its federal partners in the Program, although it has not developed a clear definition of what those costs include.

4.110 While the new management team has made progress in addressing many of the organizational issues facing the Centre, problems remain. The Centre's performance reports do not give Parliament a complete picture of how the licensing and registration activities are performing. The lack of performance standards is an urgent matter that needs to be addressed.

4.111 The loosening of information requirements so that the 31 December 2002 legal deadline for registration could be met compromised the quality of information in the registration database. The Centre has not assessed the quality of the data and does not know how many of its records are incomplete. Its plans for resolving concerns about data quality hinge on a network of volunteer verifiers. We have several concerns about the operations of this network.

4.112 We note that the integrity of the contracting process has improved since the Centre was established as a separate agency. We found that earlier contracting practices did not comply with government policies and regulations that require competitive procurement.

4.113 The cost of the main information system, CFIS I, was $190 million, including operating costs, which is significantly higher than original estimates. Although the system now works, earlier doubts about its viability and maintainability led to a second project to replace it. The cost of CFIS II was originally estimated at $32 million but is now expected to be at least $87 million. Beginning the development of CFIS II before legislation and regulations were in place repeated the errors of CFIS I, and this was responsible for some of the increased costs.

4.114 In evaluating the Canada Firearms Centre's progress in responding to our 2002 recommendation, it is important to take several factors into account: The status of the CFIS project (late and over budget) is largely due to early decisions made in 2001 and 2002; the lack of compliance with good contracting practices goes back to 1997; and the current management team inherited an organizational structure that had not stabilized. These factors imposed real constraints on how much could be done in the period since our audit in 2002. The current management team has made notable progress on a number of issues, including the establishment of a new department.

About the Audit

Objectives

The main objective of this audit was to assess the progress the Centre has made in addressing our 2002 recommendation aimed at the Department of Justice and in managing the Canadian Firearms Program.

We wished to determine if the Centre and its partners were adequately recording and reporting all of their costs and revenues associated with the firearms program.

In addition, we wished to determine the adequacy of performance reporting, contracting practices, and the development of major data systems.

Scope and approach

To review progress on reporting financial information and performance information, we did the following:

- We audited the Centre's expenditures and revenues reported in Table 3 and Table 6, respectively, of its *2004–05 Departmental Performance Report*. (We did not audit financial information reported by the Centre in prior fiscal years.) This financial information has been prepared in accordance with relevant Receiver General and Treasury Board requirements. It is the responsibility of the Centre's management, and our responsibility is to express an opinion on this information, based on our audit work. We conducted our audit in accordance with Canadian generally accepted auditing standards, which require that we plan and perform an audit to obtain reasonable assurance on whether the financial information is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial information. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial information.
- We assessed whether the Centre and its federal partners implemented adequate processes to ensure that the indirect costs reported to Parliament are reasonable; we did not audit the accuracy of indirect costs.

We audited only the performance of government organizations. We did not examine and make no comment on the performance or actions of any contracted party.

We examined files relating to performance management, contracting for the period 1997 to 2005, and the implementation of CFIS II. We did not examine the technical solution being developed for CFIS II.

We interviewed senior managers and staff at the Centre, Department of Justice, Public Works and Government Services Canada, certain of the Centre's federal partners, and the Treasury Board Secretariat. We reviewed extensive documentation, including relevant submissions to the Treasury Board. We visited chief firearms officers and attended consultation meetings with volunteer verifiers.

During the course of our work, we kept senior management informed of our progress and our preliminary findings. Except for the financial audit, the period of our audit was from May 2005 to September 2005.

Conflict of Interest Disclosure

The current Deputy Auditor General was the Acting Comptroller General of Canada during part of the period in which the decisions about the 2003–04 accounts were made: last January 2004 to early March 2004. He resigned his position in mid-February 2004 and left the employment of the Government in early March 2004. Shortly thereafter, he was named Deputy Auditor General of Canada. When the commencement of this audit was announced, he immediately disclosed that he had had an involvement in matters that might arise in the course of our audit and recused himself from all involvement in the audit. He was interviewed by the audit team in his capacity as the former Acting Comptroller General of Canada.

Criteria

We expected that the Centre's annual revenues and annual expenditures for the year ending 31 March 2005 reported in its *2004–05 Departmental Performance Report* would be fairly presented, in all material respects, in accordance with Receiver General and Treasury Board requirements.

We expected that the Centre and its federal partners would have processes in place to ensure the reasonableness of the reporting of indirect costs incurred by federal partners.

We expected that the Centre would have developed a costing methodology based on the following generally accepted criteria: cause and effect, equitability, reliability, representativeness of actual efforts, and replicability.

We also expected that the Centre would

- follow Treasury Board guidelines for the design and preparation of performance reports;
- have systems in place to monitor and improve efficiency and service to the public;
- have systems in place to manage and assure the quality of its database;
- have a model in place to estimate the quality of its database and establish targets for quality;
- comply with the Treasury Board's policy on contracting, the Government Contracts Regulations, and the Centre's contracting authorities; and
- have used lessons learned from CFIS I in developing CFIS II, and have the capacity to anticipate and adjust to change.

We expected that the governance structure for CFIS II would be based on *An Enhanced Framework for the Management of Information Technology Projects*, including such things as

- clear accountabilities,
- clearly defined roles of project leader and manager,
- in-house staffing of core responsibilities and functions, and
- project management decisions based on risk management.

Audit work completed

Audit work for this chapter was substantially completed on 15 November 2005.

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Appendix A The Gun Control Program Action Plan and its status

Announced in February 2003, the government's plan included the following actions, to be implemented in the next 12 months:	Status of actions
1. Reducing costs and improving management, by moving the National Weapons Enforcement Support Team (NWEST) to the National Police Services administered by the RCMP, to align enforcement operations; streamlining headquarter functions and consolidating processing sites; creating a continuous improvement plan to generate ongoing program efficiencies; establishing national work performance measurements and cost standards; and limiting computer system changes to projects that improve the efficiency of the program.	• NWEST was transferred to RCMP by April 2003. • Québec and Miramachi processing sites were consolidated by March 2004. • Continuous improvement plan was established. In 2005, the Centre reports over 50 elements completed, and 36 awaiting completion. • National work performance measures were established but are not relevant to operations. Refer to paragraph 4.43. • Limited changes to computer system pending development and delivery of new system.
2. Improving service to the public, by extending free Internet registration and making it more easily accessible and reliable; ensuring clients can easily access 1-800 telephone information services; processing properly completed registration applications within 30 days of receipt; and implementing a targeted outreach program to help firearm owners fulfill licensing and registration requirements.	• The Centre reports that 65 percent of registration applications from individuals were submitted on-line in 2004–05. • No telephone service levels were established. Refer to paragraph 4.45. • 73 percent of properly completed registration applications were processed within 30 days of receipt. Refer to paragraph 4.49.
3. Seeking input from parliamentarians, stakeholders, and the public, by holding consultations in spring 2003 on how to improve the design and delivery of the gun control program, and creating a Program Advisory Committee of experienced individuals external to government to provide ongoing advice on cost reductions, quality of service, and the continuous improvement plan.	• Public consultations were held and results were reported on in August 2004. • Advisory Committee was established in June 2003 and is meeting regularly.
4. Strengthening accountability and transparency, by reporting to Parliament full program costs across government; tabling an annual report to Parliament that provides full financial and performance information on the gun control program; hiring a Comptroller, who would be responsible for resource management, risk analysis, data integrity and reporting; and creating an annual audit and evaluation plan for all major program components, which would operate on a three-year cycle with the first report on results in 2005.	• Improvement in reporting full costs was noted, but clearer reporting is necessary. Refer to paragraphs 4.11 to 4.20 and 4.30 to 4.49. • Chief Financial Officer was appointed in 2003. Internal audit and evaluation plan was established. First departmental audit report was published in 2005 and is available to the public.

Appendix B *Government's Response to the Twenty-Fourth Report of the Standing Committee on Public Accounts* (selected excerpts), and the status

Recommendations	Government response	Auditor General's 2006 Status Report reference
Recommendation 1 That the Department of the Solicitor General prepare, in cooperation with its federal partners in the gun control program, a special report to be filed with the Clerk of the House of Commons no later than 31 December 2003 that provides the full costs of the Canadian Firearms Program across government together with data on the revenues collected and refunds made on a retroactive basis using an activity-based framework in accordance with the government's regulatory policy.	On October 30, 2003 the Minister of Justice tabled in Parliament the Department of Justice's Performance Report for the year ended March 31, 2003. This report included expanded information on the Canadian Firearms Program including: a fulsome discussion of the year's activity, disclosure of a full federal government cost history, net revenues and refunds, as well as a summary of program results, challenges and lessons learned. This expanded disclosure responded to the recommendations of the Auditor General and is consistent with the special report information requested by the committee. This reporting was also supported in the Gun Control Program Action Plan.	The specific report recommended by the Committee was not done. The Centre through various reports has provided much of the information. Refer to paragraphs 4.11 to 4.29.
Recommendation 2 That in those instances in which retroactive data on costs, revenues, and refunds are not available, the Department of the Solicitor General provide a full explanation in the special report.	The Departmental Performance Report referenced above contained all cost, revenue and refund information since the inception of the program in 1995-96. Limitations ... are disclosed in the notes to the schedule. None of the limitations or assumptions has a significant negative effect on the usefulness of the information. For example, amounts were rounded to the nearest one hundred thousand dollars.	Refer to paragraphs 4.11 to 4.29.

Recommendations	Government response	Auditor General's 2006 Status Report reference
Recommendation 3 That the Department of the Solicitor General include, in its special report, forecasts of costs and revenues to the point at which the Department expects the Program to become fully operational, including details on outsourcing major components of the Canadian Firearms Registration System and moving certain headquarters functions to Edmonton.	Effective in April 2003, the Canada Firearms Centre (CAFC) was established as a stand-alone department for the purposes of the *Financial Administration Act*. It is now a department within the portfolio of the Minister of Public Safety and Emergency Preparedness (formerly the Solicitor General). As such, it will now report directly to Parliament, through the Minister of Public Safety and Emergency Preparedness, on its plans and priorities on an annual basis. Its first Report on Plans and Priorities is to be tabled in Parliament in 2004. This report will reflect the Program's strategic directions, major outcomes and a forecast of costs and revenues over the planning horizon. The Gun Control Program Action Plan also recommended streamlining Headquarters function. The CAFC Headquarters has been consolidated and is now located in Ottawa.	Refer to paragraphs 4.7, 4.10 to 4.21, and 4.91 to 4.108.
Recommendation 4 That the Department of the Solicitor General include, in the special report, complete explanations for changes in costs and revenues, and changes to the overall program.	As discussed in the response to Recommendation 1, full disclosure of federal government costs and revenues for the overall program since its inception was provided to Parliament as part of the Department of Justice's 2002–03 Performance Report. Ministers are accountable to Parliament on costs outlined in the reports, and opportunities exist to seek further explanations of costs when reports are tabled.	Refer to paragraphs 4.11 to 4.29.
Recommendation 8 That the Government of Canada implement the 1997 Project Charter, making the Canada Firearms Centre at the Department of the Solicitor General of Canada the single point of responsibility and accountability for the Canadian Firearms Program.	Effective in April 2003, the Canada Firearms Centre was created as a stand-alone Department reporting to the Solicitor General, now the Minister of Public Safety and Emergency Preparedness. In this capacity, it is the central point of contact for all aspects of the Canadian Firearms Program. All federal government program costs, whether incurred directly by the CAFC or by federal or provincial partners, will be reported to Parliament in the CAFC's accountability reports ([RPP, DPR] and Commissioner's Report). The CAFC's first [RPP] is expected to be tabled in Parliament in 2004.	Refer to paragraphs 4.7, 4.22 to 4.27.

Recommendations	Government response	Auditor General's 2006 Status Report reference
Recommendation 9 That all federal participants in the delivery of the Canadian Firearms Program clearly set out their roles and responsibilities in a formal accountability framework signed by senior officials, and include this framework in the first report on the full costs of the Program.	The roles and responsibilities of federal participants are laid out in the legislative and regulatory framework of the program. Some departments and agencies carry out these responsibilities in their own right with funding provided directly by Parliament (i.e.: RCMP - [National Weapons Enforcement Support Team] NWEST and Public Works and Government Services Canada - Accommodation). Others carry out their program responsibilities on a fee for service basis (i.e.: RCMP - Canadian Police Information Centre system, Canada Customs and Revenue Agency - Import of firearms). This multi-faceted and complex program delivery structure is managed in such a way that the participants must respond in a flexible fashion to day-to-day changes in priorities. As such, it is managed on a bilateral basis rather than through one comprehensive formal accountability framework. The Centre has developed a Management Accountability Framework to guide its operations. This framework will provide the basis for the Centre's first [RPP]. The affected Departments are required by Parliament to report on their activities through regular reporting procedures such as [DPR]s and RPPs.	Refer to paragraphs 4.22 to 4.27.

Appendix C List of recommendations

The following is a list of recommendations found in Chapter 4. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraph where the topic is discussed.

Recommendation	Department's response
Financial information reported to Parliament	
4.21 The Canada Firearms Centre should ensure that the recording of project development costs over the life of the service agreement conforms to the Treasury Board's Policy on Payables at Year-End. The Centre should record costs against annual appropriations as they are incurred. (4.11–4.20)	Payment of the remaining development costs over the life of the service agreement was one element of the restructured CFIS II contract intended to provide system delivery and service incentives to the contractor. The approach to appropriation charging was developed with the support of the Office of the Comptroller General, bearing in mind the requirements of the *Financial Administration Act* and Treasury Board policy. It will be fully disclosed in all parliamentary reporting.
4.27 The Canada Firearms Centre should define what types of cost elements should be reported as the indirect costs of the Canadian Firearms Program. (4.22–4.26)	Agreed. In conjunction with the Treasury Board Secretariat and program partners, the appropriateness and content of reporting indirect costs will be reviewed. This will be completed in conjunction with the preparation of the *2005–06 Departmental Performance Report*.
Measuring and reporting of performance	
4.41 The Canada Firearms Centre should improve its reporting on the performance of the Canadian Firearms Program by providing targets and evidence-based results, and by showing through the use of a results chain how these results could contribute to public safety goals. (4.30–4.40)	Agreed. As a new department the Centre's priority has been to ensure that the program's fundamental baseline data is correct and to develop the capacity for more in-depth analysis of performance information. As the chapter notes, this has resulted in a significant increase in the performance information provided to Parliament. The Centre will continue to enhance its performance reporting as the program matures and more complete longitudinal data becomes available.
4.51 The Canada Firearms Centre should present its performance information in its performance reports in a comprehensive and complete manner that allows Parliament to fully understand the performance it has achieved and the challenges it faces. (4.42–4.50)	Agreed. As acknowledged by the Office of the Auditor General, there has been a significant increase in performance information provided to Parliament. Having established this foundation, the Centre will continue to enhance its performance reporting as the program matures and more complete longitudinal data becomes available.

Recommendation	Department's response
4.52 To improve its service to the public, the Canada Firearms Centre should analyze how long it takes to investigate and complete licence and registration applications that have client eligibility failures, identify the nature of the problems, and take appropriate action. **(4.42–4.50)**	Agreed. As identified in the Centre's 2004–05 Departmental Performance Report, client service standards are being reviewed. This review will take into consideration lessons learned during the audit, including the impact of the investigation of eligibility issues on meeting service standards. This will be done recognizing that a balance must be struck between the efficiency with which client applications are processed and the effectiveness of the investigation procedures related to public safety.
4.64 The Canada Firearms Centre should ensure that its new information system will be able to provide management with the performance information it needs to run the Canadian Firearms Registry. **(4.53–4.63)**	Agreed. The project is being assessed to ensure that the system provides appropriate operational and management information in support of all aspects of the program.
4.65 As part of CFIS II, the Canada Firearms Centre should validate addresses against information in other databases, and check all records for entry errors and completeness. **(4.53–4.63)**	Agreed. As noted in the chapter, the Centre has an ongoing plan to monitor and address data quality issues. This initiative will continue to form part of the ongoing continuous improvement plan. Specifically, the Centre will • explore cost-effective alternatives to validate address information with other databases, • examine a solution to migrate Restricted Weapons Registration System information, and • continue the process of validating data accuracy and completeness.
4.70 The Canada Firearms Centre should undertake a complete review of the volunteer Verifiers Network, including determining how many verifiers are needed, where they are needed, and how they should be managed. **(4.66–4.69)**	Agreed. As identified in the Department's *2005–06 Report on Plans and Priorities*, the development and implementation of a strategy to enhance the firearms verification process was identified as a priority. In the fall 2005, surveys were sent to 3,328 verifiers and 952 firearms owners. These surveys, in addition to the consultations with verifiers, resulted in an approach to identifying the number of verifiers needed. Additional analysis will be completed over the coming months and the resulting strategy will be implemented during 2006–07.

Recommendation	Department's response
4.73 The Canada Firearms Centre should take the necessary steps to follow up on revocation orders, including seeking the implementation of the Public Agents Firearms Regulations. **(4.71–4.72)**	Agreed. In conjunction with the implementation of the Public Agents Firearms Regulations, the Centre will review its processes regarding follow-up on revoked registration certificates.
Management of contracting	
4.88 Public Works and Government Services Canada should review how client departments use the contracting tools it has developed. It should be able to provide assurance that its tools are not being used to circumvent contracting policies and regulations. **(4.74–4.87)**	**Public Works and Government Services Canada response.** The Auditor General's recommendation identifies a weakness with the proper use of the Department's contracting tools. The Department recognizes the importance of this recommendation and is taking corrective measures to address the issues highlighted in this chapter. Such measures include training of users on accountabilities, policies, and processes, increased monitoring and reporting of usage; and, where appropriate, restricting use of the tool.
4.89 The Canada Firearms Centre should review its contracting of IT consultants to ensure that it does not create employee-employer relationships. **(4.74–4.87)**	Agreed. The Centre continues to take steps to reduce its dependence on the core group of IT consultants. As contracts of the Information Technology Services Branch of Public Works and Government Services Canada come up for renewal, they will not be extended. Additionally, the Centre has contracted the provision of IT services to a private sector service provider. As a result, the contractual relationship with the individuals in question will cease.
Contracting for the Canadian Firearms Information System	
4.108 The Canada Firearms Centre should clarify for Parliament the current status of the CFIS II system development phase. It should also clearly identify the nature of the services it is to receive during the operational 15-year period and reconcile their cost with the service charges in the original contract from 2002. **(4.90–4.107)**	Agreed. The Centre will continue to provide Parliament with improved CFIS II reporting, including information on the system development project and the nature of services to be provided over the 15-year operation period.

Chapter

5

Management of Programs for First Nations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Management of Programs for First Nations

Main Points

What we examined

In this follow-up audit, we examined the progress of five federal organizations in implementing 37 recommendations we made between 2000 and 2003 on First Nations issues. The recommendations were included in chapters that covered housing on reserves, economic development, third-party intervention, health care, the food mail program, comprehensive land claims, and reporting requirements for First Nations. We also identified factors that appear to have been critical in successfully implementing our recommendations.

Why it's important

According to numerous sources, including the Royal Commission on Aboriginal Peoples, Canada's First Nations communities face persistent challenges such as high rates of unemployment, poverty, and health problems. The federal government is responsible for fulfilling treaty and fiduciary responsibilities to First Nations people—lawful obligations that arise from treaties, the *Indian Act*, and other legislation. It is also responsible for delivering to First Nations communities social and economic programs that can directly improve the lives of the people living there—programs similar to those provided by the provinces, territories, and municipalities elsewhere in Canada. However, even though the federal government spends billions of dollars a year—just over $8 billion in 2004–05—on 360 programs and services targeted to Aboriginal peoples that address issues such as housing, health care, education, and economic development, the conditions in many First Nations communities and of many Aboriginal peoples remain significantly below the national average.

What we found

- Overall, the federal government's progress in addressing our 37 recommendations on First Nations issues has been unsatisfactory. While the issues are extremely complex, federal organizations had agreed with most of our recommendations and had committed to taking action. We found their progress on 15 of our recommendations to have been unsatisfactory. These are generally the recommendations that are most important to the lives and well-being of First Nations people. We found that little had been done to deal with the serious problem of mould in houses on

reserves. We also found that progress has been unsatisfactory in analyzing patterns of prescription drug use and drug-related deaths among First Nations people, implementing comprehensive land claim agreements, eliminating unnecessary reporting required of First Nations communities, and addressing gaps in the Third Party Manager Policy.

- Progress to date has been satisfactory on 22 of our recommendations, although in most cases implementation is not yet complete. These recommendations tend to be more administrative in nature and have less direct impact on the lives of First Nations people. For example, we found that housing programs are now better integrated and many elements are now better managed by the responsible organizations.
- In this audit, we identified seven factors that appear to have been critical in the successful implementation of our recommendations. We found that organizations were more likely to have made satisfactory progress if programs and initiatives were well co-ordinated, received the sustained attention of management, and involved meaningful consultation with First Nations. In many cases, success in implementing our recommendations was linked to the capacity of First Nations to carry out programs in their own communities and to the presence of First Nations institutions that supported the communities' economic and social development. Further, ensuring that programs and initiatives were based on appropriate legislation helped to clarify roles and responsibilities, eligibility issues, and other program elements. Finally, the different roles of Indian and Northern Affairs Canada create at least the appearance of a conflict between the Department's fiduciary responsibilities for First Nations and its obligations to act on behalf of the Crown—a conflict that has an impact on the implementation of our recommendations.

The government has responded. The government agrees that the seven factors identified by the Auditor General are important and that where satisfactory progress has been made on the Auditor General's recommendations, one or more of these factors were present. The government's overall response is included at the end of the chapter.

Introduction

5.1 According to numerous reports, including the *Royal Commission Report on Aboriginal Peoples*, First Nations people generally face far greater challenges than those faced by the wider Canadian society. While recent years have seen improvements in levels of education and economic development, high levels of unemployment, poverty, and health problems continue to pose challenges.

5.2 The federal government has established many programs and services for First Nations communities. The Treasury Board Secretariat reports that 34 federal organizations fund 360 programs and services directed to First Nations, Inuit, and Métis communities. Many of the programs directed to First Nations often parallel those delivered by provinces and municipalities in non-First Nations communities. These include programs focussed on education, health care, social assistance, and community infrastructure such as roads. Program delivery is sometimes challenging given that, according to Indian and Northern Affairs Canada data, about 60 percent of First Nations communities have fewer than 500 residents, just under 40 percent of the Status Indian population is under the age of 20, and just over 45 percent of Status Indians live in rural areas and almost 21 percent live in special access zones or remote zones.

Special access zone—A geographic zone where a First Nation has no year-round road access to the nearest service centre (supplies and equipment, a pool of skilled or semi-skilled labour, at least one financial institution, and government services).

Remote zone—A geographic zone where a First Nation is located over 350 km from the nearest service centre having year-round road access.

5.3 According to the Treasury Board Secretariat, the federal government spent almost $8.2 billion in 2004–05 on these programs and services targeted to Aboriginal peoples. Much of this funding—almost $5.1 billion—was administered by Indian and Northern Affairs Canada. Health Canada spent about $1.7 billion on health benefits for First Nations people living on and off reserves and for Inuit. Other federal organizations collectively spent over $1.4 billion.

5.4 Funding for First Nations programs has increased in recent years, but not at a rate equal to population growth. Indian and Northern Affairs Canada's funding increased by only 1.6 percent, excluding inflation, in the five years from 1999 to 2004, while Canada's Status Indian population, according to the Department, increased by 11.2 percent.

Canada's relationship with First Nations has changed

5.5 The federal government has had responsibility for "Indians, and Lands reserved for the Indians" since the *British North America Act* of 1867. The *Indian Act*, first enacted in 1876, establishes the framework for this relationship, as do historic treaties. The Act sets out conditions

affecting almost all aspects of life in First Nations communities and gives the Minister of Indian Affairs ultimate decision-making power.

5.6 The government's relationship with First Nations has changed substantially over the decades. Initially, the federal government, primarily through Indian and Northern Affairs Canada and then Health Canada, delivered programs and services directly to First Nations communities. Over time, this changed as the federal government started to delegate the administration of programs to First Nations. In the 1980s, this process accelerated as the government began to transfer or devolve more responsibility to First Nations. While First Nations now deliver many of the programs funded by the federal government, they continue to operate under delegated authority, and the ultimate responsibility for programs still rests with the departments' ministers. The relationship is still evolving, with continued emphasis on the transfer of program administration to First Nations and self-government initiatives. The relationship between Canada and First Nations is considered by the courts as *sui generis*, meaning special and unique.

The federal government has added responsibilities over time

5.7 The *Indian Act* was enacted at a time when the federal and provincial governments provided far fewer programs and services to Canadians than they do today. The same holds true for historic treaties. Since then, governments, in particular provincial governments, have assumed greater responsibilities for their citizens, through legislation and regulations, in areas such as education, health care, social housing, employment, quality of drinking water, and the environment. The federal government has also gradually assumed a variety of additional responsibilities for First Nations, often parallel to those of the provinces. Many of these are carried out through programs that are the responsibility of one department—Indian and Northern Affairs Canada.

5.8 Indian and Northern Affairs Canada carries out many roles related to First Nations on behalf of the Government of Canada. These roles include negotiating and implementing land claim agreements and the inherent right of self-government; litigating actions on a wide range of issues from Aboriginal rights and title to trust-funds management; managing a wide range of programs; developing strategies, programs, and policies; and fulfilling Canada's obligations under treaties and the *Indian Act*.

The government continues to search for solutions to long-standing problems

5.9 Over the past 35 years, the federal government has repeatedly acknowledged the need for meaningful change and a new relationship in order to correct long-standing problems. Beginning with the White Paper on Aboriginal Issues in 1969, the federal government has made numerous attempts to redefine its relationship with First Nations people and Inuit; several of these attempts were in reaction to First Nations themselves putting pressure on the government for changes. Other efforts include a Native Agenda in 1990; a Royal Commission on Aboriginal Peoples (RCAP), reporting in 1996; Gathering Strength: Canada's Aboriginal Action Plan, the government's response to the RCAP report, in 1998; the Canada-Aboriginal Peoples Roundtable, which began in 2004; and the First Ministers' Meeting on Aboriginal Issues, in November 2005. Despite these efforts, long-standing problems remain.

Focus of the audit

5.10 Since 2000, we have issued several chapters on programs and services for First Nations. In this audit, we assessed how the federal government has responded to our recommendations in several of those chapters, and we identified seven factors that appear to have been critical in successfully implementing our recommendations and realizing meaningful change.

5.11 We examined progress made by five federal organizations—Indian and Northern Affairs Canada, Health Canada, Canada Mortgage and Housing Corporation, the Treasury Board Secretariat, and Industry Canada—in responding to 37 recommendations in seven chapters completed between 2000 and 2003. Some of these chapters have also led to hearings by the House of Commons Standing Committee on Public Accounts, which subsequently led to the Committee's publishing reports containing recommendations. We followed up on recommendations in three reports from the Committee; these correspond to 21 of our recommendations. While we are not the auditors of First Nations, we did consult with a limited number of First Nations representatives. More details on the audit objectives, scope, approach, and criteria are included in **About the Audit** at the end of the chapter.

Observations and Recommendations

5.12 We expected that federal organizations would have made significant progress in implementing the 37 recommendations in seven chapters published between 2000 and 2003. We assessed the organizations' progress in implementing each recommendation as either satisfactory or unsatisfactory, taking into consideration the complexity of each recommendation and the time elapsed since we made the recommendation (Exhibit 5.1).

5.13 Overall, we were not satisfied with the progress made by the five federal organizations. We found that they made unsatisfactory progress in implementing 15 recommendations—generally those most likely to improve the lives of First Nations peoples. Although progress in implementing 22 recommendations was satisfactory, implementation was not complete for all but 3 of them. These 22 recommendations tend to be more administrative in nature and to have less direct impact on the lives of First Nations people.

Progress being realized

5.14 Our recommendations cover a wide range of programs and issues. Some of these recommendations are more administrative in nature, requiring federal organizations to take action on issues directly under their control. We found that the five organizations we examined are making satisfactory progress in implementing the majority of these, such as those related to the improved administration of health programs. Other recommendations are more complex and often require federal organizations to work closely with First Nations to develop the means to implement them. We found that federal organizations have been less successful in implementing many of these recommendations.

5.15 Improvements to First Nations programs have resulted from the implementation of recommendations in three areas: health programs, on-reserve housing, and the establishment of institutions to support First Nations economic development. However, much remains to be done to fully implement these recommendations.

Exhibit 5.1 Assessment of progress in implementing our recommendations

This list identifies each of our recommendations in chronological and numeric order, beginning with our 2000 Report, Chapter 15, Health Canada—First Nations Health: Follow-up, through to our 2003 Report, Chapter 10, Indian and Northern Affairs—Third-Party Intervention. Each recommendation is associated with a specific paragraph number in the relevant report; this number is shown in the left column for reference.

Paragraph number	Recommendation	Our assessment of progress	Progress
2000 Report, Chapter 15, Health Canada—First Nations Health: Follow-Up			
15.29	Health Canada should ensure that its program structure reflects the manner in which community health programs are actually delivered.	Health Canada realigned its program structure in 2002 to deliver three clusters of community health programs. The Department renewed its program authorities for community health programs in 2005, identifying specific objectives for each program.	●
15.31	Health Canada should continue to work with First Nations to ensure that the contribution agreements are clear about specific objectives and activities that First Nations will undertake. It should continue its efforts to encourage First Nations to define measures of success.	Contribution agreements we reviewed described the objectives of programs and activities that First Nations are to undertake. Measures of success are not well defined, although Health Canada is working with First Nations to improve them.	●
15.33	Health Canada should ensure that it receives all the activity reports required under contribution agreements. It should work closely with First Nations to improve the activity reports so that they provide information on results achieved.	Health Canada monitors and follows up to ensure that it receives activity reports as required by contribution agreements. More efforts are needed to develop outcome-focussed measures of success.	●
15.41	Health Canada should work more closely with First Nations to ensure that updated community health plans that meet the basic requirements are prepared, and that they form the basis of both initial and renewed transfer agreements.	Health Canada now requires that community health plans are prepared as required in health transfer agreements. In the sample we reviewed, Health Canada engaged First Nations and affiliated Aboriginal agencies in the development of plans.	●
15.43	Health Canada should ensure that the audit requirements under transfer agreements are met.	In the sample we reviewed, Health Canada required that the audit requirements of the transfer agreements be met.	●
15.45	Health Canada should continue to work with First Nations to improve the measurement of the services provided and of expected changes to health. These measures should be included in the annual reports, and the Department should ensure that these reports are provided.	Health Canada is working with First Nations but, in the files we reviewed, had not ensured that annual reports include measures of the services provided to First Nations communities or expected changes to health.	○
15.50	Health Canada should ensure that First Nations conduct the required evaluations of the achievement of program objectives and that future evaluations will determine the extent to which the transfer initiative contributes to improving the health of First Nations.	In the files reviewed, transfer agreements contained requirements to have evaluations of the achievement of program objectives. Health Canada receives evaluations from First Nations, but these evaluations vary in their reporting of the achievement of measurable health outcomes.	●

● **Satisfactory** — Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory** — Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Exhibit 5.1 Assessment of progress in implementing our recommendations (continued)

Paragraph number	Recommendation	Our assessment of progress	Progress
[illegible]	Health Canada should more closely monitor pharmacists' overrides of drug utilization warning messages and undertake rigorous analysis on an ongoing basis to assess the effectiveness of the messages.	Health Canada monitors pharmacists' overrides of drug utilization warning messages based on a risk profiling process. This monitoring leads to various queries, audits, and, in some cases, Health Canada's refusals of payment.	●
15.69	In cases where it identifies a significant pattern of inappropriate use of prescription drugs, Health Canada should continue to perform a rigorous follow-up with Non-Insured Health Benefits clients, physicians, pharmacists, and professional bodies. Health Canada should ensure that it has the means to implement this action.	For five-and-a-half years (May 1999 to November 2004), Health Canada did not conduct drug use evaluation (DUE) analysis to identify significant patterns of inappropriate use of prescription drugs and was therefore not in a position to follow up with clients, physicians, pharmacists, and professional bodies. More recently, Health Canada resumed certain types of DUE analysis, but it is not yet able to identify reduction of inappropriate use of prescription drugs due to its interventions. It also began to follow up with community and health care professionals. The Department established a Drug Utilization Advisory Committee to develop and recommend a comprehensive program to promote safe, effective, and efficient use of drugs.	○
15.71	Health Canada should systematically gather data on prescription drug-related deaths of First Nations individuals in all regions.	Although Health Canada committed to liaise with provinces and territories on prescription drug-related deaths, we found no evidence that it has done so. Health Canada told us that this measure to assess prescription drug misuse was not feasible and could not be implemented.	○
15.74	Health Canada should continue to build on its existing strategies to address the combined problem of prescription drug abuse and solvent and alcohol abuse, and increase efforts in community health programs relating to prevention, community education, and treatment of prescription drug addiction.	Health Canada has continued to focus on the combined problems of drug, alcohol, and solvent abuse through community health programs. These include producing and promoting educational programs and developing new tools to combat emerging drug abuse problems such as crystal methamphetamine.	●
15.89	Health Canada should enforce the contract requirements for audit of pharmacy and dental care providers and reporting by the contractor. The Department should continue to take steps to strengthen verification of claims and audits of providers.	Health Canada now enforces the contract requirements for audits of pharmacies and dental care providers. Audits of pharmacies have increased significantly.	●
15.97	Health Canada should establish clear program criteria and minimum standards for medical transportation benefits [illegible] undertake audits of medical transportation expenditures based on an assessment of risks.	Fully implemented. In 2003, Health Canada developed and implemented a Medical Transportation Policy Framework to clarify key program criteria and revised it in 2005. The Department has also conducted risk-based audits on medical transportation expenditures.	●

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○ **Unsatisfactory** — Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Exhibit 5.1 Assessment of progress in implementing our recommendations (continued)

Paragraph number	Recommendation	Our assessment of progress	Progress
15.100	Health Canada should ensure that it completes an evaluation of each of the Non-Insured Health Benefits transfer pilot projects, as well as an overall evaluation of the pilot exercise.	Health Canada has conducted evaluations on each of the Non-Insured Health Benefits pilot projects established between 1996 and 2003. It has produced a draft overall evaluation of the pilot exercise, which it plans to finalize in 2006.	●
2001 Report, Chapter 12, Follow-Up—Indian and Northern Affairs Canada—Comprehensive Land Claims (1998 Report, Chapter 14)			
12.121	Indian and Northern Affairs Canada should enhance the achievement of certainty by addressing differing expectations relating to rights, capacity, and implementation of claim settlements.	There are still fundamental disagreements between the parties involved on the meaning of "certainty." There are also differing interpretations on the implementation of settlements. Indian and Northern Affairs Canada has made an effort to build capacity within First Nations, but more is required.	
12.121	Indian and Northern Affairs Canada, together with other settlement parties, as applicable, should expedite the treaty process and ensure adequate rigour in determining the nature and amount of assets to be included in the settlement.	Six agreements have been signed since our last audit of 2001. These have averaged 29 years to finalize. Four of these agreements are from the Yukon, where 11 of 14 outstanding claims have been signed. There are more than 50 claims outstanding elsewhere in Canada. The Department has told us that it has established guidelines and procedures that it says will ensure rigour in determining the nature and amount of assets to be included in settlements.	○
12.121	Indian and Northern Affairs Canada should strengthen implementation plans, improve reporting, and conduct evaluations of settlement impact.	Indian and Northern Affairs Canada developed guidelines for implementing land claim agreements in 2004. They refer to the need for government to track obligations and activities, but do not propose that implementation plans focus on objectives and measurement of results. We also reviewed the implementation plans for three agreements signed in 2005. We found they do not set objectives, but rather commit the federal government to specified activities supporting obligations. The Department maintains that the focus on objectives can be achieved outside the medium of implementation plans. It has promoted results-based management in the annual reports produced by implementation committees through conducting results-based planning and reporting workshops during 2005. As well, in response to our 1998 chapter, the Department completed a Comprehensive Claims Evaluation Framework in 2002. It now has a draft plan for the evaluation of the impacts of comprehensive land claim agreements. The plan indicates that a pilot evaluation of a land claim agreement will be completed by February 2007.	○

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Exhibit 5.1 Assessment of progress in implementing our recommendations (continued)

Paragraph number	Recommendation	Our assessment of progress	Progress
[illegible]	Indian and Northern Affairs Canada should report the complete costs of reaching and implementing settlements and compare them with relevant budgets.	Indian and Northern Affairs Canada stands by its previous assertions that it tracks costs sufficiently, although it does not track departmental administration costs or the costs to other departments. It states that the small amount of additional information gained from changing its systems would not be worth the investment needed.	○
	2002 December Report, Chapter 1, Streamlining First Nations Reporting to Federal Organizations		
1.61	The federal government should consult with First Nations to review reporting requirements on a regular basis and to determine reporting needs when new programs are set up. Unnecessary or duplicative reporting requirements should be dropped.	Federal departments generally recognize the need to reduce the reporting burden, and there have been isolated efforts to consolidate reports. However, the overall reporting burden on First Nations has not been reduced.	○
1.64	The federal government should use the most efficient procedures to submit and process reports [illegible] First Nations communities to file reports electronically where it is practical to do so.	The Treasury Board Secretariat is leading an effort to consolidate reporting requirements of First Nations, but improvements have yet to be realized. Indian and Northern Affairs Canada is leading an initiative to facilitate electronic reporting for many communities but has yet to implement it.	○
1.87	The federal government should undertake a review of program authorities to streamline the programs and better allocate program responsibilities among departments and other federal organizations.	The Treasury Board Secretariat is currently leading a review of all federal government programs for First Nations communities. Through this review, the Secretariat has identified 360 programs and services targeted to Aboriginal peoples and delivered by 34 federal organizations. Work is in progress to consolidate program terms and conditions where appropriate.	●
	2002 December Report, Chapter 11, Other Audit Observations—Indian and Northern Affairs Canada—Food mail program		
[illegible]	Indian and Northern Affairs Canada should undertake a review of the location of its major entry points.	Indian and Northern Affairs Canada has not undertaken a review of the major entry points for the food mail program, as previously recommended. Instead, it reviewed only one of the program's entry points. It has no immediate plans to review any others, but the Department indicates that based on the results of pilot projects under way in three communities, it is exploring the merits of program amendments, including a review of additional entry points.	○

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○ **Unsatisfactory** — Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Exhibit 5.1 **Assessment of progress in implementing our recommendations (continued)**

Paragraph number	Recommendation	Our assessment of progress	Progress
2003 April Report, Chapter 6, Federal Government Support to First Nations—Housing on Reserves			
6.38	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in consultation with First Nations, should reach a broad agreement on their respective roles and responsibilities in addressing the housing shortage on reserves.	Fully implemented. Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in collaboration with the Assembly of First Nations and regional First Nations organizations, have jointly developed a management control framework that defines their respective roles and responsibilities for addressing housing shortages on reserves.	●
6.44	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation should streamline their program structure and delivery.	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in consultation with First Nations representatives, jointly developed a new allocation methodology for the Budget 2005 housing initiative to streamline processes for clients and allow more efficient cash management and flexibility in planning.	●
6.48	Indian and Northern Affairs Canada, Canada Mortgage and Housing Corporation, and Health Canada, in consultation with First Nations, should develop a comprehensive strategy and action plan to address the problem of mould on reserves.	Indian and Northern Affairs Canada, Canada Mortgage and Housing Corporation, and Health Canada have not developed a comprehensive strategy and action plan aimed at mitigating mould in houses on reserves. Instead, each federal organization is active with its own program, which collectively entails education, training, assessments, renovations, and research on mould and prevention techniques. Without a strategy and action plan, the scale of the problem has not been identified, priorities for action have not been established, and there is no comprehensive plan for co-ordinating departmental efforts or monitoring overall progress.	
6.53	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in consultation with First Nations, should provide reasonable assurance that all federally subsidized housing on reserves meets the National Building Code.	In the two regions we examined, the files of Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation indicate that the appropriate codes and standards were met, including those in the National Building Code.	●
6.64	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in consultation with First Nations, should ensure that community housing plans are used as intended by the 1996 housing policy.	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation have made improvements in their use of community housing plans. Documentation indicates that these housing plans are being used to share information and co-ordinate funding between the two federal entities. These plans are also being considered in the allocation of funds from the Budget 2005 on-reserve housing program. Canada Mortgage and	●

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Exhibit 5.1 Assessment of progress in implementing our recommendations (continued)

Paragraph number	Recommendation	Our assessment of progress	Progress
		Housing Corporation has also developed training aids and has begun to deliver training to First Nations' housing providers.	
6.74	Canada Mortgage and Housing Corporation should strengthen its internal controls for subsidy payments and, in consultation with First Nations, ensure compliance with operating agreements.	Canada Mortgage and Housing Corporation has improved its monitoring and internal control mechanisms for housing subsidy agreements. This includes a review and sign off of financial statements, and enhanced site visits and physical inspections.	●
6.79	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation, in consultation with First Nations, should define, collect, and use reliable information to manage on-reserve housing assistance.	Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation (CMHC), working in conjunction with the Assembly of First Nations, have adopted a revised allocation methodology to better define, collect, and use information for on-reserve housing. Although the Department and CMHC have improved their process for obtaining accurate information for on-reserve housing, more is needed to verify its accuracy.	●
6.84	Indian and Northern Affairs Canada should seek approval from the Treasury Board for the terms and conditions of the 1996 housing policy. The Department should provide its regional offices with sufficient guidance and training to ensure that the policy is properly understood and applied consistently.	Fully implemented. Indian and Northern Affairs Canada obtained approval from the Treasury Board on the terms and conditions of the 1996 housing policy in March 2005. Regions were informed of the formal approval during national workshops.	●
6.88	Indian and Northern Affairs Canada should evaluate its interim policy on shelter allowances and approve a final policy with necessary changes resulting from the evaluation, while taking into account approved funding levels.	Indian and Northern Affairs Canada completed an evaluation of its interim shelter allowance policy in April 2005. The Department is developing a national strategy on shelter allowances based on the outcome of this evaluation.	●
6.94	Indian and Northern Affairs Canada, in co-operation with Canada Mortgage and Housing Corporation, should improve its reporting to Parliament. It should clearly articulate its expected results; report on costs, program performance, and results; and clarify how the reported outputs have an impact on the critical housing shortage.	Indian and Northern Affairs Canada has worked with Canada Mortgage and Housing Corporation to identify how many housing units it plans to build and improve, what has been built, and how much the program costs. However, it has not identified how well the program is working to alleviate the critical housing shortage on reserves.	

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Exhibit 5.1 Assessment of progress in implementing our recommendations (continued)

Paragraph number	Recommendation	Our assessment of progress	Progress
2003 November Report, Chapter 9, Economic Development of First Nations Communities—Institutional Arrangements			
9.82	The federal government should support First Nations in identifying, planning, and implementing institutional arrangements that take advantage of economies of scale where possible, and that are appropriate to the First Nations' economic development circumstances and visions.	Indian and Northern Affairs Canada has an action plan for its economic development programs resulting from a new structure to increase community economic capacity. In addition, the Department has identified, planned, and begun to implement four new First Nations institutions to support economic development and capacity.	●
9.90	Under the leadership of Indian and Northern Affairs Canada, federal organizations should develop horizontal performance information for economic development programming that is outcome-focussed and relevant to the performance information needs of First Nations.	Indian and Northern Affairs Canada has identified outcome-focussed performance information for its Community Economic Development program. However, the Department has yet to measure and report against these performance measures.	○
2003 November Report, Chapter 10, Other Audit Observations—Indian and Northern Affairs Canada—Third-Party Intervention			
10.46	Indian and Northern Affairs Canada should address the elements missing from its new Third Party Manager Policy, namely provision for First Nations input, chief and council capacity building, and dispute resolution.	Indian and Northern Affairs Canada has not addressed elements missing from its 2003 Third Party Manager Policy. The Department is developing a new policy, which may be in place by April 2006. This policy is expected to include provisions for First Nations input, chief and council capacity building, and dispute resolution. Until then, these provisions are not formally available to First Nations subject to this policy.	○
10.47	Indian and Northern Affairs Canada should develop a strategy and action plan for implementing the new Third Party Manager Policy.	Indian and Northern Affairs Canada has developed an action plan to implement its 2003 policy. In September 2005, the Department also began to develop a new strategy to accompany the new policy expected in April 2006. The Department informs us that it plans to have an action plan in place by the time the new policy is approved.	●
10.48	In consultation with First Nations, Indian and Northern Affairs Canada should conduct an evaluation of third-party manager intervention.	Indian and Northern Affairs Canada has not conducted an evaluation of the effectiveness of third-party manager intervention, although it has conducted compliance reviews. As such, the new policy being developed (planned for April 2006) does not benefit from a formal evaluation of third-party management process.	○

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Improvements have been made in administering health programs funded through agreements

5.16 Health Canada has made satisfactory progress in implementing the majority of recommendations we made in our 2000 audit, which focussed on managing programs funded through agreements. Since 2000, we have seen some significant improvements in the administration of these programs. For example, after several years of effort, Health Canada revised its medical transportation policy to clarify program eligibility and benefits. The Department also implemented a risk-based audit framework to better manage its medical transportation benefits.

5.17 The preparation and use of community health plans have also improved. As part of the process for transferring health programs to communities, First Nations are required to develop community health plans. These are intended to identify community health-related priorities, programs to be undertaken, and the roles and responsibilities of the Medical Officer of Health Services and other professionals. These health plans are to be prepared prior to Health Canada entering into or renewing transfer agreements with First Nations.

5.18 In 1997 we found that renewed transfer agreements were often not based on updated community health plans, and we recommended that this basic requirement be met before any new and renewed transfer agreements were signed. In 2000 we looked at this issue again and found that Health Canada was still sometimes approving transfer agreements without updated community health plans. Without such plans, Health Canada had little assurance that health funding was being effectively targeted to community health priorities.

5.19 In this audit, we found that the administration of program requirements has improved in several respects. Community health plans are now updated, and First Nations conduct audits prior to renewal of transfer agreements. Health Canada also revised the terms and conditions for community health programs to ensure that requirements are adhered to. More generally, Health Canada has increased the controls in its administration of transfer and contribution agreements to ensure that funding is used effectively and targeted to community practices. Again, while progress is satisfactory, the original recommendations, except for one, have not been fully implemented.

Improvements have been made in managing First Nations housing programs

5.20 Numerous studies have noted that poor housing negatively affects the health, education, and overall social conditions of individuals and communities on reserves. In 2001 Indian and Northern Affairs Canada estimated a shortage of about 8,500 on-reserve housing units and that an additional 44 percent of the existing 89,000 houses on reserves required renovations. According to the Department, the housing stock generally deteriorates more rapidly on reserves, due mainly to substandard construction practices or materials, lack of proper maintenance, and overcrowding.

5.21 In 2003 we audited the federal government's delivery of housing programs on First Nations reserves. We found that Indian and Northern Affairs Canada and Canada Mortgage and Housing Corporation (CMHC) had not clearly defined what the programs were intended to achieve in terms of reducing the critical housing shortage; nor had these organizations defined a time frame for achieving this. We also found that the funding mechanisms and programs were very complex and that the Department, CMHC, and First Nations did not agree on their respective roles and responsibilities.

5.22 In this audit, we found that the programs are now better integrated. This was achieved in consultation with First Nations, in response to their concerns. We also found that Indian and Northern Affairs Canada and CMHC had strengthened the management of many elements of their housing programs.

5.23 For example, to help facilitate the implementation of the Department's housing policy, CMHC worked with participating First Nations to develop community housing plans that link housing funds and programs with training, job creation, work opportunity programs, and economic development activities. In 2003 we found that these plans were not being used as intended and their implementation was not being monitored. In this audit, we found that Indian and Northern Affairs Canada and CMHC are now using community housing plans to identify the housing stock and as a tool to make decisions on new units to be built or units to be renovated. While this represents considerable progress, serious problems, notably mould contamination, remain (see paragraphs 5.34 to 5.36).

The government has established more institutional arrangements for economic development

5.24 The 1996 *Royal Commission Report on Aboriginal Peoples* documented substantial gaps between Aboriginal and non-Aboriginal

peoples in Canada for key economic indicators. In 2003 we examined the role of institutional arrangements in sustaining economic development. We identified various barriers to economic development, such as First Nations' lack of access to economic development resources, lack of access to federal business support, and lack of approaches to institutional development. We recommended that the federal government support First Nations in identifying, planning, and implementing institutional arrangements, appropriate to First Nations' economic development arrangements, circumstances, and visions.

5.25 In this audit, we found that the federal government has developed a new program structure to provide greater flexibility in responding to communities' economic development requests. In consultation with First Nations, it has also identified, planned, legislated, and begun to establish four new First Nations institutions, which, among other things, are intended to provide First Nations with the access to private capital enjoyed by other governments.

5.26 We view the establishment of institutions as an important step in assisting First Nations' economic development. Considering other audits we have reported in recent years (Drinking Water in First Nations Communities, 2005 Report of the Commissioner of the Environment and Sustainable Development; Indian and Northern Affairs Canada—Education Program and Post-Secondary Student Support, November 2004 Report of the Auditor General), we believe additional opportunities may exist for creating institutions in areas such as health and safety, and education.

Urgent action needed to implement key recommendations

5.27 We found that some of the recommendations that would likely make a significant difference in the lives and well-being of First Nations people and Inuit were not being implemented or that progress was unsatisfactory. These include recommendations on conducting prescription drug use analysis and analyzing prescription drug-related deaths, developing a strategy and action plan for addressing mould in houses on reserves, eliminating unnecessary reporting required of First Nations communities, implementing land claim agreements, and addressing gaps in the Third Party Manager Policy.

Inadequate monitoring of prescription drug use continues

5.28 Through its Non-Insured Health Benefits program, Health Canada funds prescription drugs for eligible First Nations people living on and off reserves and for Inuit. In 1997 and in subsequent audits, we identified that the Department was slow to intervene where potentially

inappropriate use of prescription drugs was observed and that it was not monitoring the number of prescription drug-related deaths of those covered by its drug benefits program.

5.29 In our 2000 audit, we found that Health Canada had started conducting analysis of prescription drug use. This intervention, involving follow-up with clients, physicians, pharmacists, and professional bodies, had some positive impact. However, the Department stopped conducting this analysis in May 1999 because management was unsure of the appropriateness of doing so without either a legislative mandate that would explicitly allow for this type of analysis, or client consent, which would grant permission to the Department to analyze private health information. We also found that the Department had not analyzed data on drug-related deaths of its clients. In 2001 officials informed the Public Accounts Committee that it expected to resume analysis of prescription drug use for 70 percent of its clients within the year, after it had received consent. Even though we identified publicly reported information on prescription drug-related deaths of First Nations people—information that was available to Health Canada, the Department told the Committee that it was not within its purview to gather data on deaths related to prescription drugs.

5.30 In our 2004 audit of the management of federal drug benefits programs, we found that Health Canada had not conducted any analysis of prescription drug use since 1999. Instead, it had spent the previous four years trying to obtain client consent. It had obtained consent for only about 25 percent of clients before stopping this effort in March 2004. We found that the number of clients obtaining more than 50 prescriptions over a three-month period (a criterion used by some provincial bodies to identify cases for review) had almost tripled compared with what we found in our 2000 audit.

5.31 Part of the reason that Health Canada sought consent before conducting analysis of prescription drug use was that it did not have a legislative base for its program, which would have identified rights and obligations of the Department and its clients. We first identified this issue in a 1993 audit, in which we found that the program's authority was unclear due to the absence of specific enabling legislation. We found that the Non-Insured Health Benefits program lacked definitions of purpose, expected results, and anticipated outcomes. We recommended that Health Canada seek from the government a renewed mandate for the Non-Insured Health Benefits program to clarify the authority base, purpose, and objective of the program.

5.32 In 1997 we found that, instead of seeking enabling legislation, the Department had proposed only a renewed policy mandate. This did not address the need to clarify the authority base, rights, and obligations of the Department. In 2000 we again observed that there was still no specific legislation for the Non-Insured Health Benefits program, even though the program entailed more than $530 million in annual expenditures.

5.33 In this audit, we found that Health Canada still does not gather data on prescription drug-related deaths. Nor has it sought enabling legislation for its Non-Insured Health Benefits program. In November 2004, the Department resumed its analysis of prescription drug use, but, at the time of our audit, it was not yet able to identify reductions of inappropriate prescription drug use due to its intervention. Its current approach is only to seek consent, on a case-by-case basis, from those clients for whom the Department has not already done so, before informing health providers or pharmacists of concerns related to prescription drugs. There is still no enabling legislation for the Non-Insured Health Benefits program, and the rights and obligations of the Department and its clients have not been defined.

Mould contamination in houses on reserves continues to be a significant problem

5.34 Mould is a fungus that, under certain conditions, produces poisonous substances that can cause headaches, dizziness, and nausea. Indian and Northern Affairs Canada has identified the main factors contributing to mould in housing as a lack of proper care and maintenance, inadequate air circulation and ventilation, poor site selection and drainage, overcrowding, and improper construction. For several years, mould contamination has been identified as a serious health and safety problem in First Nations communities.

5.35 In 2003 we found that Indian and Northern Affairs Canada, Canada Mortgage and Housing Corporation, and Health Canada organized and were participating in a committee intended to address the mould problem. However, none of these federal organizations had fully assessed the extent of mould contamination in houses on reserves and the full cost of remediation, or developed a comprehensive strategy or action plan to address the problem.

5.36 In this audit, we again found that despite the activities of the committee, no federal organization has taken responsibility for assessing the extent of the problem and developing a comprehensive strategy for addressing it. Although Health Canada is responsible for health and safety, its programming is restricted to research and expert

inspections when called upon to determine if the dwelling is fit to live in and advise on the corrective action required. Canada Mortgage and Housing Corporation provides education and training workshops, and Indian and Northern Affairs Canada provides financial contributions to support housing renovations, including activities to correct mould buildup. However, without management's sustained attention, facilitated by a strategy or action plan, the scale of the problem has not been identified, priorities for action have not been established, and no overall plan for co-ordinating federal organizations' efforts or monitoring overall progress has been developed. Without a strategy and action plan to address this problem, First Nations communities may continue to experience premature deterioration of their housing stock and negative health effects on their people.

Reporting requirements still need to be overhauled

5.37 In 2002 we looked at the amount of reporting required of First Nations by federal organizations. We estimated that four federal organizations required at least 168 reports annually from First Nations communities—many with fewer than 500 residents. We found that many of these reports were unnecessary and, moreover, were not used by the federal government. We recommended that the government review reporting requirements and eliminate those that were duplicate or unnecessary, use the most efficient procedures to submit and process reports required from First Nations, and undertake a review of program authorities.

5.38 After more than a year of little progress by federal departments to reduce the reporting burden in response to our recommendations, the Treasury Board Secretariat took the lead to organize interdepartmental sessions and to map out the extent of federal involvement with First Nations. As a result, it determined that 34 federal organizations currently deliver 360 programs and services targeted to Aboriginal peoples. It also linked funding to programs and, for the first time, was able to report on programming by federal organizations.

5.39 This broad analysis by the Treasury Board Secretariat confirms the seriousness of the problem we identified in 2002. In our current audit, we found that meaningful action by the federal government is still needed to reduce the unnecessary reporting burden placed on First Nations communities and to develop more efficient procedures for obtaining information required. Officials told us that Indian and Northern Affairs Canada alone obtains more than 60,000 reports a year from over 600 First Nations. As we noted in 2002, the resources

devoted to the current reporting system could be better used to provide direct support to communities.

Deficiencies in implementing comprehensive land claim agreements persist

5.40 Comprehensive land claims relate to Aboriginal rights and title to land that have not been dealt with by treaties or other legal means. Settling comprehensive land claims involves negotiating and implementing complex, modern treaties. In 1998 we audited Indian and Northern Affairs Canada's role in reaching and implementing comprehensive land claim agreements. Among other things, we found that implementation plans were inadequate or non-existent, and we observed that the Department tracked only activities and processes, not results produced and costs incurred. We recommended that the Department strengthen implementation plans, improve reporting, and conduct evaluations of the implementation of land claim agreements.

5.41 The Public Accounts Committee issued several recommendations after considering our audit. These recommendations directed the Department to establish indicators and a timetable for measuring and reporting the economic benefits produced as a direct result of settlements; include specific provisions for timely and periodic impact evaluations; provide information in its annual performance report on the outcomes achieved as a result of comprehensive land claim agreements; and specify how it would improve its monitoring of, evaluation of, and reporting on the implementation of comprehensive land claim agreements.

5.42 The Department responded that it would develop an evaluation framework to evaluate the social and economic benefits of land claim agreements, and it would consider including such information in its performance report. It further stated that it expected to have made significant progress by December 1999 in developing a multi-year plan to evaluate the implementation of land claim agreements.

5.43 In 2001 we followed up on this audit and found that the Department needed to continue its efforts to strengthen implementation plans and accelerate its efforts to evaluate the implementation of agreements. We also noted the difficulty in achieving certainty and the length of time needed to reach agreements. In addition, in a 2003 audit of Indian and Northern Affairs Canada's management of the land claim agreements for Inuit of Nunavut and the Gwich'in of the Northwest Territories, we noted that managing land claims well means focussing not only on meeting

specific obligations of the claims but on achieving measurable results against objectives.

5.44 In our current audit, we found that in 2004 the Department had published guidelines for implementation in response to our 1998 recommendation that the Department strengthen implementation plans, improve reporting, and conduct evaluations of the implementation of land claim agreements. These guidelines refer to the need for the government to track obligations and activities, but they do not propose that implementation plans focus on objectives and measuring results.

5.45 We also reviewed the implementation plans for three agreements signed in 2005, with a view to determining whether they focus on objectives and results, not only on obligations and activities supporting obligations. We found that the plans do not set out objectives, such as reducing unemployment rates to specified levels, but rather commit the federal government to specified activities supporting obligations, such as establishing a community services agency. The Department maintains, however, that the primary role of implementation plans is to ensure that all obligations of the parties are identified and addressed through agreed-upon activities, and that it is pursuing the measurement and reporting of results outside the medium of implementation plans (for example, promoting results-based management in annual reports produced by implementation committees through conducting results-based planning and reporting workshops).

5.46 Indian and Northern Affairs Canada has not evaluated the implementation of land claim agreements, as we recommended in 1998. Only in 2002 did the Department prepare a Comprehensive Claims Evaluation Framework. It now has a draft plan for evaluating the impacts of comprehensive land claim agreements. The plan indicates that a pilot evaluation of a land claim agreement will be completed by February 2007. In our opinion, without a focus on objectives and results, along with the evaluation of their attainment and impacts, the federal government does not have a means of measuring, reporting, and ensuring the successful implementation of land claim agreements.

Gaps in the Third Party Manager Policy have not been addressed

5.47 When a First Nations community delivering a program or service under a funding arrangement with Indian and Northern Affairs Canada fails to meet its obligations, the Minister has the right to

intervene. At the highest level of intervention, the Department selects a third party to take over the management of the funding arrangement until the problems are resolved. In 2003 we identified various deficiencies in the Department's administration of the third-party management process. One of these was the lack of a strategy for building the capacity of First Nations management to end third-party management.

5.48 We recommended that the Department address missing elements from its Third Party Manager Policy, adopted in 2003—namely, provision for a dispute resolution mechanism, building of capacity of chiefs and councils, and provision for First Nations input in the third-party manager selection process.

5.49 In this audit, we found that the Department has not revised its 2003 policy. Instead it has proposed to have provisions for these missing elements in a new policy expected in April 2006. Similarly, the Department has not evaluated the effectiveness of third-party manager intervention as we had recommended. As such, the new policy being developed does not benefit from a formal evaluation of the third-party management process. Further, the present policy still does not include a strategy to build the capacity of First Nations management to end third-party management.

Critical Factors

Factors that appear to have been critical in implementing our recommendations

5.50 As a result of our follow-up audit work, as well as interviews with senior officials across the federal government, we identified seven factors that appear to have either enabled the successful implementation of our recommendations or, by their absence, hindered their implementation and, in turn, impeded significant change in the lives of First Nations people and Inuit.

Sustained management attention

5.51 Management's sustained attention is critical to realizing substantive change in government generally. We saw this in Health Canada's revisions to its medical transportation policy and audit processes. Similarly, it is because of management attention that federal organizations have finally started to take action to begin implementing recommendations in two cases where progress has not been satisfactory. In the first case, after five-and a-half years of not conducting analysis of prescription drug use, the focussed attention of

senior management resulted in Health Canada implementing a new program for analysis of prescription drug use. In the second case, the Treasury Board Secretariat took responsibility in 2004 to begin rethinking how government programs and services are structured, in the context of the expenditure and management reviews launched in Budgets 2003 and 2004. This initiative responded to the concerns raised in our 2002 chapter on streamlining First Nations reporting to federal organizations. Officials we interviewed emphasized that sustained attention on the part of senior management will be required to effect lasting change. While much remains to be done in both these areas (analysis of prescription drug use and structuring of government programs and services), the continued attention, leadership, and commitment of senior management to sustained action are required if the government is to successfully implement all our recommendations and make First Nations programs more effective.

Co-ordination of government programs

5.52 Co-ordination among federal organizations delivering similar programs is crucial to efficient and effective programming and to implementing many of our recommendations. These recommendations point to the need for organizations to co-ordinate their programs and the requirements they place on First Nations. Senior federal officials we interviewed emphasized that the lack of a co-ordinated approach to First Nations programs is often a problem. They also noted that programs, many of which are similar, are typically "stove-piped"—that is, they are narrowly defined and often overlap and duplicate each other. We also noted this in our 2002 chapter on streamlining First Nations reporting to federal organizations and in our 2003 chapter on housing on reserves. However, efforts related to some of our recommendations (for example, those on the administration of the housing and economic development programs) indicate that it is possible for federal organizations, working with First Nations, to co-ordinate the planning, management, and delivery of programs.

Meaningful consultation with First Nations

5.53 We found that meaningful consultation often contributes to or results in significant change. Meaningful consultation refers to open engagement and dialogue between the federal government and First Nations on the objectives to be achieved and the means of attaining these. More than half of our recommendations highlight the importance of organizations moving forward in consultation with First Nations. For the most part, we found that federal organizations made

satisfactory progress in implementing recommendations that included engaging in meaningful consultation with First Nations (for example, many of the recommendations in our 2003 chapter on housing on reserves).

5.54 We also found that the absence of meaningful consultation can impede successful implementation of our recommendations. For example, in its efforts to conduct analysis of prescription drug use, Health Canada sought to obtain consent from clients to conduct analysis using their private drug records. This initiative resulted in the Department obtaining consent from only about 25 percent of its First Nations clients after four years of effort, by the time the initiative was cancelled in March 2004. First Nations attributed this failure to Health Canada's not taking into account the need for community engagement in monitoring and addressing risks associated with prescription drug use.

Developing capacity within First Nations

5.55 The federal government's success in implementing many of our recommendations has depended in large part on the capacity of the First Nations to carry out the implementation of programs in their communities. In our chapters on housing on reserves, third-party intervention, and economic development, we noted the need for more effective capacity development of First Nations. The government agreed with our recommendations and has started to work with First Nations to develop the institutions required to provide them with the technical support they need to deliver effective programs. Federal officials we interviewed stressed the importance of capacity building and development as a means to improve delivery of programs.

Establishing First Nations institutions

5.56 We found that establishing First Nations institutions is important to improve the health and the economic and social development of First Nations communities. Several senior officials we interviewed noted the importance of developing a stable and professional First Nations public service to administer programs devolved by the federal government, and that establishing First Nations institutions could facilitate this. As referred to earlier (paragraph 5.25), the four First Nations institutions recently developed hold promise for greater investment and economic opportunities in First Nations communities. Given the need and importance of such institutions, and the interest of First Nations in developing them, the opportunity exists to establish more of these institutions.

Appropriate legislative base for programs

5.57 A legislative base for programs clarifies respective roles and responsibilities, eligibility, and other program elements. For example, in the area of prescription drug use analysis and the potential for serious harm caused by the misuse of prescription drugs, we noted the absence of specific enabling legislation and recommended that the Department seek a renewed mandate to clarify the authority base, purpose, and objective of the program. In this case, the absence of a legislative base caused confusion among government officials and clients about the jurisdiction, allocation of responsibilities, and rights of the Department and clients. We noted that Health Canada has not sought a legislative mandate for its Non-Insured Health Benefits program. Senior officials have also noted the importance of such a mandate for identifying and clarifying the rights and obligations of both the federal organization and its clientele.

5.58 The *Indian Act*, established in 1876, is widely considered to be an outdated piece of legislation that, for the most part, does not address current issues. Housing, education, and health and safety are examples of areas where legislation now exists provincially but where there is little federal legislation that applies to First Nations.

5.59 In other cases, new legislation has served to provide a sound foundation for initiatives. The government has brought forward legislation for the successful conclusion of land claims and the development of new institutions. In addition, Indian and Northern Affairs Canada and First Nations have also co-operated in developing the *First Nations Land Management Act*, *First Nations Oil and Gas and Moneys Management Act*, and the *First Nations Commercial and Industrial Development Act*. We found that the processes leading to the successful legislation in these instances had the following common elements: First Nations proposed the legislation to address roadblocks to progress they had identified, and the legislation resulted from successful negotiations and addressed First Nations needs. We noted that the legislation assisted the federal government in meeting its stated policy objectives, and the legislation includes the provision for optional participation of individual First Nations.

Conflicting roles of Indian and Northern Affairs Canada

5.60 In many of the areas we examined in this audit, Indian and Northern Affairs Canada relates to First Nations in several different roles, sometimes at cross-purposes with one another. Senior government officials told us that they recognize that there is at least

the appearance of conflict in the many roles that the Department is required to fulfill.

5.61 We noted this potential for conflict in the Department's roles in the area of negotiating and implementing land claim agreements, where the legalistic and narrow interpretation used to negotiate land claim agreements seems to have spilled over into their implementation. In our past work, we found that Indian and Northern Affairs Canada took the position that its responsibilities related to the implementation of land claim agreements should be defined by what the agreements state its obligations to be. First Nations have said that there must be a federal commitment to achieve the broad objectives of the land claim agreements and self-government agreements within the context of the new relationships, as opposed to the federal government strictly complying with narrowly defined obligations. We believe that these differing roles of the Department create at least the appearance of a conflict and may have resulted in an erosion of trust between the Department and First Nations over time.

Conclusion

5.62 Federal organizations have made unsatisfactory progress in implementing almost half of our recommendations, generally those addressing issues having the greatest impact on the lives of First Nations people and Inuit. These include recommendations on analyzing prescription drug use and related deaths, developing a strategy and action plan for addressing mould in houses on reserves, eliminating the requirements for unnecessary reports from First Nations communities, implementing comprehensive land claim agreements, and addressing gaps in the Third Party Manager Policy.

5.63 Federal organizations are making satisfactory progress in implementing other recommendations; however, most of these are not yet fully implemented. These recommendations tend to be more administrative in nature and have less direct impact on the lives of First Nations people and Inuit.

5.64 We identified seven factors that appear to have been critical in the successful implementation of our recommendations. These include the sustained attention of management, co-ordination of government programs, meaningful consultation with First Nations, development of First Nations capacity, establishment of First Nations institutions, development of an appropriate legislative base for programs, and consideration of the conflicting roles of Indian and Northern Affairs

Canada. In our view, ensuring that these factors are fully considered when adjusting existing programs and implementing new ones will make a significant difference in the lives of Aboriginal people.

Government's overall response. The Government of Canada agrees that the seven factors identified by the Auditor General are important. It is clear that where satisfactory progress has been made on the Auditor General's recommendations, one or more of these factors were present. In addition, they constitute an increasingly important part of the government's approach for the broader Aboriginal agenda. Examples include the following:

- The First Ministers Meeting of 24–25 November 2005 in Kelowna, British Columbia demonstrated a willingness of the federal, provincial, and territorial governments and national Aboriginal organizations to develop a common Aboriginal agenda for the future in important areas such as housing, health, education, and economic opportunities. Moving forward will continue to require sustained management attention.

- The Aboriginal Horizontal Framework initiative of the Treasury Board Secretariat provides an excellent base for determining the effectiveness of government programs and increasing the level of co-ordination to minimize gaps and overlap.

- The consensus-based decision making displayed at the Kelowna First Ministers Meeting by leaders of federal, provincial, and territorial governments and national Aboriginal organizations is a prime example of meaningful consultation with First Nations and other partners, including Aboriginal partners.

- Progress made in establishing legislative authorities in partnership with First Nations through the *First Nations Oil and Gas and Moneys Management Act*, the *First Nations Fiscal and Statistical Management Act* and the *First Nations Commercial and Industrial Development Act* contributes to the establishment of appropriate First Nation institutions and will assist in developing the capacity of First Nations.

- With respect to the last two critical factors cited, namely the establishment of a legislative base for programming, and addressing the conflicting roles of Indian and Northern Affairs, the federal government continues to examine new approaches to improving the way its responsibilities are delivered and has made important recent advancements in legislative and regulatory renewal on reserve, in partnership with First Nations.

While the government's actions are consistent with the factors identified, resolving Aboriginal issues remains an extremely difficult challenge, characterized by complex jurisdictional issues. Taking on major reforms is complex, requires staging over time, and is supported by the establishment of strong governance and accountability measures in First Nations communities. As First Nations communities are unique in their history, geography, socio-economic conditions, internal capacity, vision, and priorities, our approaches must be tailored to meet these diverse and distinctive attributes of First Nations people.

The Government of Canada is pleased to continue to take the critical factors into account when developing approaches aimed at securing a better future for Aboriginal peoples.

About the Audit

Objectives

Our audit objectives were

- to assess the progress that Indian and Northern Affairs Canada, Health Canada, Canada Mortgage and Housing Corporation, the Treasury Board Secretariat, and Industry Canada have made in implementing our recommendations in seven previous reports on First Nations programs; and
- to identify, as a result of this assessment, the factors that enabled or impeded federal organizations in their efforts to implement our recommendations.

Scope and approach

This follow-up audit assessed the progress of the five above-noted federal organizations in responding to 37 recommendations in seven reports of the Office of the Auditor General published from October 2000 to November 2003. We did not follow up on the progress of two additional recommendations made in the reports as they are not currently applicable. The seven reports are the following:

- October 2000, Chapter 15, First Nations Health Follow-Up
- November 2001, Chapter 12, Follow-Up of Recommendations in Previous Reports: Indian and Northern Affairs Canada—Comprehensive Land Claims (1998, Chapter 14)
- December 2002, Chapter 1, Streamlining First Nations Reporting to Federal Organizations
- December 2002, Chapter 11, Other Audit Observations: Indian and Northern Affairs Canada—Food Mail Program
- April 2003, Chapter 6, Federal Government Support to First Nations—Housing on Reserves
- November 2003, Chapter 9, Economic Development of First Nations Communities—Institutional Arrangements
- November 2003, Chapter 10, Other Audit Observations: Indian and Northern Affairs Canada—The Department needs to improve third-party intervention

Additional chapters referred to include Transferring Federal Responsibilities to the North (November 2003 Report of the Auditor General, Chapter 8), Management of Federal Drug Benefits Program (November 2004 Report of the Auditor General, Chapter 4), Education Program and Post-Secondary Student Support (November 2004 Report of the Auditor General, Chapter 5), and Drinking Water in First Nations Communities (2005 Report of the Commissioner of the Environment and Sustainable Development, Chapter 5).

The chapters containing the recommendations we assessed had the following attributes:

- They were published from 2000 to 2003. We considered this time frame appropriate for recommendations to still be relevant, while it also allowed sufficient time for meaningful progress to have been made.

- They addressed a wide variety of issues that dealt with government priorities, including the need to support First Nations capacity, deliver programs more effectively, and monitor performance,
- They focussed on several federal organizations so we could assess how well their programs and activities were integrated.

We also reviewed recommendations from the House of Commons standing committees on Public Accounts and on Health as they relate to the chapters within the scope of our audit. The Public Accounts Committee published three reports and the Health Committee published one report. We tracked progress on 21 of the recommendations included in these reports.

For each chapter and recommendation, we reviewed files, statistics, and other documentation that organizations submitted to our Office as part of our ongoing monitoring. We then conducted interviews and reviewed documentation at the headquarters of all five federal organizations. We also conducted interviews and detailed file reviews in the British Columbia and Ontario regional offices of Indian and Northern Affairs Canada, Canada Mortgage and Housing Corporation, and Health Canada. In addition, we interviewed a limited number of First Nations representatives, seeking their perspectives on progress, barriers, and effective practices.

To consider fully the factors that we identified that appear to have been critical in the successful implementation of our recommendations, we interviewed senior officials who provided their views at a more general and broad-based level than our specific recommendations. We also gained the perspectives of selected First Nations representatives, both at program-specific and more general levels. Finally, our cumulative observations, gained through numerous audits and over several years, are also reflected in this assessment.

Criteria

We expected each federal organization to have

- implemented the recommendations for which they are responsible;
- implemented the recommendations within the time frames and according to the commitments originally made;
- set out revised time frames in which to implement recommendations, where original time frames or commitments had not been met; and
- identified barriers to their implementation, where revised time frames had not been set out for implementing recommendations.

These criteria were derived from numerous past audits and are consistent with Office methodology. All the organizations in the scope of our audit have agreed to them.

Audit work completed

Audit work for this chapter was substantially completed on 16 December 2005.

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Chapter

6

Management of Voted Grants and Contributions

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the [illegible] we also draw upon the standards and practices of other disciplines.

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Management of Voted Grants and Contributions

Main Points

What we examined

We assessed the extent to which the government has ensured effective government-wide management and control over the spending of public money through voted grants and contributions. We last reported on this issue in 2001. This time, we looked at a sample of grant and contribution programs and assessed the adequacy of their management and control by the departments administering them (Canadian Heritage, Human Resources and Skills Development Canada, Indian and Northern Affairs Canada, Public Health Agency of Canada, and Social Sciences and Humanities Research Council of Canada). To assess the application of the Policy on Transfer Payments, we included both departments that were part of our previous audit and some that were not.

We also assessed the completeness and clarity of the policy framework and guidance issued by the Treasury Board.

Why it's important

The government currently spends about $17.5 billion a year on voted grants and contributions. It uses them as financial incentives for a recipient individual or organization to carry out an activity that helps to further government policy and a department's objectives. Properly planned and managed, grant and contribution programs give recipients a reasonable chance of success in the funded activities without contributing more public money than the recipient needs for the activity.

What we found

- Overall, the government has made satisfactory progress since 2001 in the management of grants and contributions. Four of the departments we audited had satisfactory controls over the management of grant and contribution programs: they have adopted risk-based approaches to monitoring the funded activities of grant and contribution recipients, prepared clear documentation on their assessment of applications, developed grant and contribution management systems, and established training for officials of grant and contribution programs. At Indian and Northern Affairs Canada we found weaknesses in each of those areas.

- The Policy on Transfer Payments and the guidance on applying it provide a basis for effective control over the use of grants and contributions. However, the available types of transfer payments do not meet departmental needs.
- Recipients of grants and contributions have told a parliamentary committee their concerns about the way departments apply the Treasury Board's Policy on Transfer Payments. They said that meeting various requirements including multiple audits, demonstrating eligibility for funding, and reporting on recipients' results—can impose a heavy financial and administrative burden. Our audit confirmed that departments have yet to streamline their management of grants and contributions in a way that would resolve those concerns.

The Treasury Board Secretariat and the departments have responded. The Treasury Board Secretariat and the departments agree with all of our recommendations. In their responses, the Secretariat and the departments describe the actions they will take to address our recommendations.

Introduction

Transfer payments are payments for which no goods or services are directly received, but which may require the recipient to provide reports and be subject to audit.

Grants are unconditional transfer payments made to individuals or organizations that have met established eligibility requirements. Recipients of grants are not subject to audit.

Contributions are conditional transfer payments made to individuals or organizations that are based on a contribution agreement and are subject to audit and reporting requirements.

6.1 The government pursues public policy through legislation and regulation; tax measures; transfer payments to individuals, organizations, and other levels of government; and by providing services, information, and advice. **Transfer payments** to individuals and organizations are generally **grants** or **contributions**. While the government does benefit directly when it pays for goods or services through a procurement contract, it does not when it awards a grant or contribution.

6.2 Some spending through grants and contributions is statutory, which because it has continuing authority by an act of Parliament does not require Parliament's approval every year. Statutory expenditures include old age security payments and guaranteed income supplement payments. In contrast, voted grants and contributions must receive parliamentary approval through an annual appropriation act. All references to grants and contributions in this chapter refer to voted grants and contributions.

6.3 The government currently spends about $17.5 billion a year on grants and contributions. Grants and contributions are used as financial incentives to influence recipients (individuals or organizations) to carry out activities that help achieve the government's policy goals and a department's objectives.

6.4 Management requirements that government policy imposes on departments are different for grants and contributions. Once recipients meet the eligibility criteria for a grant, they can usually receive it without meeting further conditions. However, the recipient of a contribution must meet the monitoring and performance requirements, specified in the terms and conditions of a contribution agreement, to be reimbursed for project costs.

Key findings in 2001

6.5 In chapters 4 and 5 of our 2001 Report, we reported on the management of grant and contribution programs, government-wide and in specific departments. Following hearings for that audit, the Standing Committee on Public Accounts made recommendations to the Treasury Board Secretariat concerning risk management, monitoring departmental operations, and providing guidance for program managers and officers on managing transfer payment programs.

6.6 We reported on departmental management of grant and contribution programs. We noted weaknesses in

- the process for assessing funding applications;
- risk management as a tool for cost-effectively managing programs; and
- financial controls, especially for managing payments to recipients.

6.7 We also reported that the Treasury Board had revised the Policy on Transfer Payments in 2000. To promote a results-based approach to designing and managing grant and contribution programs with a focus on strengthening control and accountability, the policy required that departments

- use better risk-management practices,
- specify and measure the intended results of programs, and
- improve cash management.

Important changes since 2001

6.8 The Policy on Transfer Payments is designed to ensure sound management, control, and accountability for transfer payments in government programs. For example, departments must submit the terms and conditions of their grant and contribution programs to Treasury Board for approval and establish controls to manage and monitor the recipient's use of funds. These controls include establishing criteria for screening recipients for eligibility, auditing recipients' use of funds, and monitoring program results.

Terms and conditions —This chapter refers to two types of terms and conditions. Program terms and conditions are the requirements that must be approved by the Treasury Board before a department can create or renew a transfer payment program. Agreements with grant and contribution recipients also include specific terms and conditions.

6.9 To supplement the Policy on Transfer Payments, the Treasury Board Secretariat has issued guidance documents including

- Guide for the Development of Results-based Management and Accountability Frameworks;
- Risk-Based Audit Framework Guide; and
- Guide on Grants, Contributions, and Other Transfer Payments.

6.10 At the same time as our audit, the Secretariat began to revise the Policy on Transfer Payments, as required by the current policy.

Focus of the audit

6.11 The objective of our audit was to determine the extent to which the government has ensured effective government-wide management and control of the spending of public money through grants and contributions.

6.12 We assessed

- the design, implementation, and effectiveness of the control frameworks for managing grants and contributions;
- whether the government responded to our past recommendations and those of the Standing Committee on Public Accounts;
- whether the government has a complete and clear policy framework, provides oversight for effective management of grants and contributions in a manner sensitive to risks, and is accountable for results;
- the nature and extent of the Treasury Board Secretariat's monitoring, including the status of the required renewals of the terms and conditions for all grant and contribution programs, to take place by their expiry date or 31 March 2005, whichever came first; and
- the departmental management and control of grant and contribution programs to ensure that they adequately address the design stipulated in their approved Treasury Board submission.

6.13 In our detailed file review, we included

- Canadian Heritage—Development of Official-Language Communities Program;
- Human Resources and Skills Development Canada—Summer Career Placements Initiative;
- Indian and Northern Affairs Canada (INAC)—Contributions to Support the Building of Strong Governance, Administrative and Accountability Systems (Gathering Strength);
- Public Health Agency of Canada—Community Action Program for Children; and
- Social Sciences and Humanities Research Council of Canada (SSHRC)—Indirect Costs of Research Program.

In 2006, Human Resources and Skills Development Canada became Human Resources and Social Development Canada.

6.14 To assess the application of the Policy on Transfer Payments, we included departments that were part of our previous audit and some that were not (INAC and SSHRC).

Basic services represent social services provided to all Canadians. Indian and Northern Affairs Canada's basic service programs parallel provincial programs for the same social benefit

6.15 Grants and contributions may also include payments for **basic services**, such as education and social assistance to First Nations, Inuit, and other northern Canadians delivered by INAC. Our audit did not include the management of these payments. There is more information about our scope, approach, and criteria in **About the Audit** at the end of this chapter.

Observations and Recommendations

The role of the Treasury Board Secretariat

6.16 The Treasury Board sets government-wide policies, such as the Policy on Transfer Payments. Under this policy the Treasury Board approves the terms and conditions for all grant and contribution programs. The Treasury Board Secretariat is responsible for providing guidance to departments to implement this policy and is responsible for monitoring the application of the policy.

6.17 We expected that since our 2001 audit, the Secretariat would have given the departments guidance to help them interpret and apply the Policy on Transfer Payments; we found that it has done so.

The policy and guidance on transfer payments provide a basis for effective control

6.18 The Secretariat is responsible for reviewing a department's proposed terms and conditions for transfer payment programs to ensure that they meet the Policy on Transfer Payment requirements including those for clearly stated objectives, identification of eligible recipients, and a framework for measuring results.

6.19 We examined the terms and conditions for the five programs included in our sample and all of them met the requirements of the policy.

6.20 The existing policy and guidance, and the Secretariat's review and Treasury Board's approval of proposed terms and conditions, provides a basis for effective control. However, there could be more variety in the types of transfer payments available to departments and some aspects require clarification to ensure greater consistency.

The current Policy on Transfer Payments requires refinements to meet departmental needs

6.21 The range of departmental requirements for accountability and results measurement cannot always be met with either grants or contributions as they are defined in the policy. In the absence of

choices, some programs have created their own transfer payment types that include elements of both grants and contributions. For example, while Social Sciences and Humanities Research Council of Canada (SSHRC) uses grants to fund their Indirect Costs of Research Program, it uses a risk-based audit framework to monitor its recipients and requires them to report on results according to SSHRC's results-based management and accountability framework.

A results-based management accountability framework and a risk-based audit framework were introduced in the 2000 Policy on Transfer Payments.

A **results-based management and accountability framework** is used to identify a program's performance measures and develop strategies to report on outcomes.

A **risk-based audit framework** is used to identify specific risks to transfer payment programs, monitor the risks, and conduct recipient and internal audits as needed to mitigate the identified risks.

6.22 By definition recipients of a grant are not subject to audit. However, the Policy on Transfer Payments requires a risk-based audit framework, which includes developing a component for the conduct of recipient audits. This aspect of a risk-based audit framework is more consistent with the definition of a contribution.

6.23 Clear direction has not been provided to departments on how to choose between the existing transfer payment types. Because of inadequate guidance, departments have developed a variety of practices. For example

- The Official Languages Support Programs Branch at Canadian Heritage has a rule that if a risk assessment indicates that a recipient is low risk, project funding under $25,000 and core funding under $50,000 could be grants, and all transfer payments over these amounts must be contributions; and
- Human Resources and Skills Development Canada funds its Summer Career Placement Initiative through contribution agreements with recipients (employers) for amounts as small as $1,800. These contribution funds are given to support student summer employment.

6.24 Recommendation. The Treasury Board Secretariat should ensure that

- the types of transfer payments available to departments meet the variety of needs for their programs,
- the definitions of transfer payment types and their associated requirements are consistent, and
- guidance is provided on how to select transfer payment types so that selections are consistent across departments.

The Treasury Board Secretariat's response. Agreed. The Treasury Board Secretariat is pleased that the Office of the Auditor General has recognized that the existing policy and guidance, as well as the review and approval by the Treasury Board of program terms and conditions, provides a basis for effective control of transfer payments.

Further improvements are being considered through the policy review and other guidance to enable consistent approaches across government that allow for a better balance between risks, control, and accountability for results.

The Treasury Board Secretariat is committed to incorporating departmental, central agency, and stakeholder experiences into policy revision. In this regard, it hopes to increase the number of transfer payment options available to departments, thereby responding to their various needs while continuing to allow for flexibility as further needs arise.

The Treasury Board Secretariat will update the accompanying guidance material to facilitate consistent approaches across government, including the selection of suitable transfer payment instruments. The implementation strategy being considered for the proposed revisions to the Policy on Transfer Payments will facilitate an integrated approach to sharing knowledge and best practices through training programs and interdepartmental activities.

A risk-based approach to reviewing terms and conditions is needed

6.25 When the Treasury Board revised the Policy on Transfer Payments in 2000, it stipulated that the terms and conditions for all grant and contribution programs were to expire no later than 31 March 2005. All departments needed Treasury Board approval to renew all program terms and conditions before that date to be able to continue programs. Because some departments have not met this deadline, the deadline had to be extended to allow the programs involved to continue until the required renewal of their terms and conditions.

6.26 Even though there were over 700 grant and contribution programs, the policy did not have a risk-based approach for reviewing program terms and conditions. Rather, it set a fixed expiry date, regardless of the degree of risk in the individual programs. A more measured, risk-based approach to reviewing program terms and conditions would have reduced the extra workload this requirement caused the Secretariat and departments.

The Treasury Board Secretariat needs to facilitate the sharing of best practices

6.27 The Treasury Board Secretariat is responsible for monitoring departmental use of grants and contributions to

- ensure that Policy on Transfer Payments objectives are met,

- identify better practices, and
- identify any systemic weaknesses in applying the policy.

6.28 In 2001, we recommended that the Secretariat strengthen its monitoring of departmental procedures for managing grants and contributions. The Standing Committee on Public Accounts made a similar recommendation. The Secretariat has partially responded to these recommendations.

6.29 We found that the Secretariat has compiled a list of government transfer payment programs and is analyzing program evaluation results. We reported in our November 2004 Report that the Secretariat reviews the internal audit reports it receives, but does not have a process to ensure that it receives all completed internal audit reports. Therefore, the analysis of completed reports and the monitoring of departmental use of grants and contributions may be limited.

6.30 We also noted that departments had concerns about insufficient sharing of best practices and were calling for the Secretariat to re-establish an interdepartmental working group on transfer payments. Creating a group to discuss concerns in applying the Policy on Transfer Payments and share best practices for managing grants and contributions would provide another means for the Secretariat to monitor departmental operations.

6.31 Recommendation. The Treasury Board Secretariat should establish and co-ordinate an interdepartmental working group on transfer payments to discuss concerns about applying the Policy on Transfer Payments and share best practices for managing grants and contributions.

The Treasury Board Secretariat's response. Agreed. Interdepartmental initiatives that focus on exchange of knowledge and best practices in transfer payments are key success factors. Results of departmental consultations in the review of the Policy on Transfer Payments reveal that there is strong support for the re-establishment of such an interdepartmental working group. The Treasury Board Secretariat is including such an initiative as part of its planned implementation strategy for the proposed revisions to the Policy on Transfer Payments.

The Treasury Board Secretariat needs to monitor the Task Force on Community Investment

6.32 The Policy on Transfer Payments is subject to review at least once every five years. As part of the 2005 review, the Treasury Board Secretariat asked departments if they had any concerns with the Policy

and, as a result of these consultations, decided that it should be rewritten. Departmental concerns included clarification of their responsibilities for maintaining internal control frameworks and monitoring the costs and results for transfer payment programs. The Secretariat's consultation with departments is a positive step.

6.33 In our view, the Secretariat also needs to continue to consult the government's newly formed (March 2005) Task Force on Community Investment, which is examining federal policies and practices on transfer payments that affect interaction with the voluntary sector. The task force is scheduled to complete its work in early 2007. The results of its consultation may offer useful input to the Secretariat on the nature and extent of guidance that may be required. Consulting this task force is particularly appropriate since the voluntary sector includes some of the same organizations that receive federal grants and contributions.

The **voluntary sector** consists of non-profit organizations, registered charities, and non-incorporated volunteer groups.

6.34 Recommendation. The Treasury Board Secretariat should continue to monitor the work of the Task Force on Community Investment and amend the Policy on Transfer Payments and guidance for transfer payments as necessary.

The Treasury Board Secretariat's response. The Treasury Board Secretariat is committed to continuing its engagement with the Task Force on Community Investments and to building on the lead role it played in the development of the Voluntary Sector Initiative guidance publication, A *Code of Good Practice on Funding*. The Secretariat will continue to be involved both at the Steering Committee and working levels so as to better understand the needs of the voluntary sector. This understanding will feed into ongoing processes related to improvements to the Policy on Transfer Payments, and to the accompanying directives, guidance materials, and practices.

The role of departments and agencies

6.35 In our current audit, we looked at the management control frameworks that departments established to set policy and to provide guidance and tools for managing grants and contributions, and how the frameworks responded to the 2000 Policy on Transfer Payments. We then looked at a sample of departmental programs to assess whether the design of the management control framework was carried out and whether it had provided sufficient guidance to the program officers who manage grants and contributions.

The design of departmental management control frameworks to manage grants and contributions is reasonable

6.36 We found that the departments had developed policies and procedures to govern grants and contributions within departmental programs and had issued guidance to staff managing grants and contributions. While the clarity and complexity of the guidance varied considerably across departments, it did provide a framework for managing grants and contributions.

6.37 Departments had also established delegated signing authorities to manage grant and contribution programs.

Overall department performance was satisfactory

6.38 We assessed the progress made by Human Resources and Skills Development Canada (HRSDC), Canadian Heritage, and Public Health Agency of Canada (PHAC) since our 2001 audit (Exhibit 6.1).

Exhibit 6.1 Progress in addressing our recommendations

	Eligibility	Monitoring	Financial management	Departmental capacity
HRSDC	●	●	●	●
Canadian Heritage	●	●	●	●
PHAC	●	●	●	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

6.39 Since two of the departments included in this status report, Indian and Northern Affairs Canada (INAC) and Social Sciences and Humanity Research Council of Canada (SSHRC), were not part of our previous audits of grants and contributions, we have not reported their progress. We do comment on whether we found their existing controls to be satisfactory or unsatisfactory.

Eligibility refers to the extent to which a department ranks applications according to objective assessment criteria, and documents its assessment of the project's eligibility for funding.

6.40 Eligibility. The HRSDC system for ranking applicants is the most transparent and objective of the programs we examined, as it informs all applicants about the ranking criteria and the expected results.

6.41 We noted that in administering this program, HRSDC provides its list of recommended and non-recommended projects for a constituency to its Member of Parliament for the Member's concurrence on funding listed projects. Our audit did not assess the Member of Parliament concurrence process.

6.42 Canadian Heritage, SSHRC, and PHAC also met our audit criteria, and we found their processes for assessing applicants' eligibility to be satisfactory.

6.43 We assessed INAC as unsatisfactory because half of the program files we examined did not indicate that the department assessed whether the proposed project met the program's terms and conditions. Because the regional program officers responsible for the Gathering Strength Program did not receive their budgets from headquarters until late in the fiscal year, they had no idea how much money (if any) they had for grants and contributions. Since funds must be allocated before the end of the fiscal year, they had little time to do eligibility assessments as required. In one region, they did not advise potential recipients of the availability of funds for this program and decided by themselves which organizations to fund. By not requesting applications, there is a risk that INAC has not considered all potential projects for funding.

Monitoring refers to whether or not a department's monitoring activities are commensurate with the level of risk inherent in a given project.

6.44 Monitoring. HRSDC, Canadian Heritage, and SSHRC received satisfactory ratings because they follow a documented risk-assessment process, with the level of risk determining how much they monitor and how many reports they require from recipients. We noted that HRSDC's risk-assessment process was rigorous and used objective criteria, including projects' dollar values, previous experience with recipients, and recipients' organizational capacity and public profile.

6.45 We consider PHAC's progress to be satisfactory. We noted that the way it had determined the appropriate level of monitoring varied from region to region and did not always consider the risk level of the recipients. PHAC recognized this; it now has an effective risk assessment methodology and is taking steps to have all regions adopt it.

6.46 INAC received an unsatisfactory rating because its management control framework stipulates that monitoring and reporting requirements are largely determined by the program and do not consider the risk level of the recipients. In the program that we audited, we found no evidence that risk assessments had been done to determine the appropriate frequency and depth of monitoring or reporting.

For the purposes of this chapter, **financial management** refers to a department's cash management and compliance with the *Financial Administration Act* and the Policy on Transfer Payments.

6.47 **Financial management.** The objective of the cash management requirement in the Policy on Transfer Payments is to ensure that departments only advance funds to recipients as needed, which generally means that funds are advanced in instalments.

6.48 HRSDC, Canadian Heritage, SSHRC, and PHAC received satisfactory ratings because they followed the Policy on Transfer Payments' cash management requirements.

6.49 Based on the results of our statistical sample, we gave INAC an unsatisfactory rating for a number of reasons, including the following:

- INAC does not analyze or challenge differences between the amounts originally budgeted for specific items and the amounts actually spent. For example, one project (value $151,750) had a project management budget of $36,500. The audited financial statements showed that the cost of this item had risen to $62,198. INAC's program officer did not question the increase or attempt to determine where money had been shifted from in order to cover the increased cost of managing the project. In contrast, other departments in our sample had set limits of 10 percent to 15 percent on changes to budget allocations. If a change in budget allocations exceeded these thresholds, the recipients were required to obtain departmental approval.
- The Department did not require recipients who received more than $100,000 for a project to provide a statement about other sources of proposed funding.
- Project officers did not hold back final payments on one project until the recipient had fulfilled all the terms of its contribution agreement, as required by the Act and the Policy on Transfer Payments.
- The Department did not reclaim unspent money from a project within a reasonable time, as is required by the Policy on Transfer Payments when funding exceeds actual expenses. In one case, even though a recipient owed money to the Crown for non-qualifying expenditures in 2001 and 2002, the Department did not seek repayment until 2004.

Departmental capacity refers to a department's infrastructure—the tools, automated systems, procedures, and trained people needed to run grant and contribution programs effectively.

6.50 **Departmental capacity.** Since our 2001 audit, all departments we examined have developed automated systems for managing grants and contributions. Some systems are more comprehensive and have a greater level of control than others. For example, HRSDC's system has built-in features and controls to ensure that program officers responsible for grant and contribution projects follow rigorous

management procedures. In 2004, INAC began to develop a new grants and contributions management system to replace its current system, which was designed only to support its cash management. The existing system has not automated all the controls for reducing risk and promoting sound management. INAC's main objectives for developing a new system are to ensure that a consistent business process is followed for grants and contributions and key controls are enforced at the appropriate times. We support this initiative.

6.51 Four of the five departments (HRSDC, PCH, SSHRC, and PHAC) have made satisfactory progress in developing appropriate training programs for managing grant and contribution projects.

6.52 INAC offers no formal training for program officers who manage grant and contribution projects. Even though INAC has developed policies and procedures and issued guidance to program officers to govern the use of grants and contributions, we found that the lack of training contributed to a lack of consistency in applying its control framework.

6.53 In our view, this lack of training and the narrow focus of its grants and contributions management system have helped to create many of INAC's problems. For example, we noted instances where program officers, in managing their grants and contributions, did not clearly understand the requirements of the *Financial Administration Act*. Section 34 of the Act states that before a payment is made for grants and contributions, the responsible departmental officer must certify that the payee is entitled to the payment. In addition to using section 34 to certify payments, we found examples of section 34 certifications being used for reasons unrelated to issuing funds.

6.54 Recommendation. Indian and Northern Affairs Canada should strengthen its grant and contribution management controls by

- preparing a risk-assessment of recipients to determine the appropriate frequency and depth of monitoring and reporting,
- completing the development and implementation of its automated management system for grants and contributions, and
- providing necessary training to its program officers.

Indian and Northern Affairs Canada's response. Indian and Northern Affairs Canada agrees with this recommendation. The Department recognizes the importance of the issues raised in this chapter and is committed to improving and strengthening its grants and contributions management processes.

The development of a new First Nations and Inuit Transfer Payment System is the most important initiative currently under way, which will further improve and strengthen management practices. The Office of the Auditor General is supportive of this automated grants and contributions management system.

Indian and Northern Affairs Canada recognizes and fully supports the importance of providing ongoing training to its staff. It also recognizes the need to adopt a risk-based approach to manage all grants and contributions, and determine eligibility and the appropriate level of monitoring and reporting.

The Department will continue to work closely with the Treasury Board Secretariat to develop a Policy on Transfer Payments that meets both departmental and recipient needs.

All departments have developed a results-based management and accountability framework

6.55 The Treasury Board's 2000 Policy on Transfer Payments requires departments to use a results-based management and accountability framework (RMAF). Our audit found that all five departments developed RMAFs for their programs. We did not audit the implementation of INAC's RMAF as it was only approved by the Treasury Board in August 2005. The RMAFs of the other four departments include evaluation plans and strategies to report on program outcomes that are being reported in the departmental performance reports. The strategies included in the RMAFs have not yet been completed because these are generally based on a five-year plan. Therefore, we have determined that the implementation and use of RMAFs is in progress.

Recipients have raised concerns about administrative burdens

6.56 In the spring of 2005, parliamentary hearings were held to inquire into certain directives that HRSDC had issued for funding various community programs. These directives contained various administrative, management, and accountability requirements for contribution programs.

6.57 As part of our audit, we reviewed the reports of these hearings and found that recipients of grants and contributions had a number of concerns with the directives on audit and reporting requirements, the administrative burden of complying with the directives, the length of time it took HRSDC to approve their projects, the lack of multi-year funding for long-term projects, and the need to re-apply each year for

these projects. Other departments have surveyed organizations that have received funding through grant and contribution programs on a range of issues related to the application of the Policy on Transfer Payments. These surveys and our audit findings tend to reinforce findings of the parliamentary hearings, indicating that those concerns are not unique to HRSDC's recipients.

6.58 We noted that while some departments are trying to respond to recipients' concerns, they could do much to streamline their procedures and reduce recipients' administrative burden. The following paragraphs describe the typical concerns recipients had about departmental processes for approving and managing contributions.

6.59 **There are delays in negotiating agreements and receiving approvals.** In a survey conducted by Canadian Heritage, clients indicated that they had to wait an average of seven months before receiving decisions on their applications. The wait time for the Official Languages Support Programs Branch is five and a half months. We noted similar wait times in the statistical sample of files we examined. Long delays mean that when an organization eventually receives funding, it may have little time left to begin a project. In other departmental programs we examined, program officers were able to have agreements in place by the beginning of the fiscal year.

6.60 **Organizations must re-apply annually, even for long-term projects.** Two of the five programs examined were core programs:

Core programs are long-term and are typically conducted by the same recipients who receive grants and contributions year after year to provide services to Canadians.

- the Development of Official Language Communities Program at Canadian Heritage, which provides funds to support French- and English-speaking minority communities; and
- the Community Action Program for Children (CAPC) at PHAC, which funds community coalitions to promote the health and development of young children.

6.61 We found that despite the long-term nature of core programs and the continuing relationship between departments and recipients, departments still require recipients to submit annual applications. This requirement results in added administrative costs for recipients and wasted departmental time and resources. Multi-year agreements, which take into account appropriate risk factors and previous experience with the recipient, would eliminate re-application costs. PHAC has addressed this concern by entering into multi-year agreements with CAPC recipients. However, such agreements are the exception rather than the rule.

6.62 Monitoring and reporting requirements are often redundant. An organization that receives funding for different programs from one or more departments may be required, by the terms and conditions of the contribution agreement, to submit an audited financial statement to the program officer responsible for each program. The organization may also be audited by each department from which it received funding; witnesses appearing at the parliamentary committee hearing cited instances when they were subject to more than one financial audit within the same fiscal year. This process is cumbersome and duplicates work for the departments and the recipient.

6.63 We looked at the practices of other jurisdictions and noted that the United States federal government has a single-audit process for organizations whose funding from more than one federal program exceeds an established funding threshold. This is a highly co-ordinated practice that enforces one audit for each recipient of federal money, rather than multiple audits of a recipient, as is generally the practice in Canada. Single audits are risk-based, include compliance work over program specifics, and include both high-dollar and low-dollar, high-risk programs. Although the Policy on Transfer Payments encourages departments to consider a single audit approach where appropriate, the Secretariat does not provide the resources or procedures for this approach.

6.64 Recommendation. The government should co-ordinate and implement a single audit process for the recipients of transfer payments from federal programs.

The Treasury Board Secretariat's response. Agreed. There is a need to reduce the audit burden placed on recipients while ensuring an appropriate level of control and accountability. A coordinated single recipient audit regime will be pursued to the extent possible.

The Treasury Board Secretariat's commitment to improving management aims to better promote horizontal management and the integration of activities that will assist departments to focus on exchanges of knowledge and promotion of best practices. Program design and administration must be client focused including, wherever possible, common and integrated recipient audit requirements. Interdepartmental initiatives will be undertaken to facilitate implementation and to highlight best practices in areas of streamlined recipient auditing.

Some departments have taken constructive steps in response to recipients' concerns

6.65 To date, some departments have taken constructive steps in response to recipients' concerns raised during Parliamentary hearings. However, much remains to be done to streamline departments' management of transfer payments.

6.66 HRSDC and SSHRC have simplified their application forms and clearly explain how the recipients' performance will be measured, and what information they must provide for evaluations. This reduces uncertainty and helps to ensure that recipients will provide the necessary performance information.

6.67 PHAC funds two programs: one relating to pre-natal care, the other to promoting the health and development of children up to six years old. Some recipients run both programs and must report similar information for each. Program officers in Atlantic Canada consolidated their information requests for reporting and evaluation requirements, which allows recipients to submit one report instead of two. Such initiatives reduce administrative work for the department and the recipients.

6.68 **Recommendation.** The Treasury Board Secretariat and departments, while balancing risk, control, and accountability for results, should streamline the application, reporting, and audit requirements for grants and contributions in ways that would reduce the administrative burden on recipients.

The Treasury Board Secretariat's response. Agreed. The administrative burden on recipients must be reduced through streamlined application, reporting and audit requirements to the extent possible.

The proposed revisions to the Policy on Transfer Payments and to the supporting guidance material will provide best practices on how to streamline application, reporting, evaluation, and audit requirements. Interdepartmental initiatives will enable the sharing of knowledge and best practices between departments on how to reduce the administrative burden. Guidance will also be provided on reducing the administrative burden on the recipient population.

Periodic assessments of departmental transfer payment programs will address the extent to which streamlined application, reporting, and audit requirements are being implemented, which would in turn reduce the administrative burden on recipients.

Conclusion

6.69 While the Policy on Transfer Payments provides a basis for effective control, the Secretariat needs to further improve its monitoring of departmental operations. We also noted that the policy needs to expand the types of transfer payments available to departments to better respond to program needs.

6.70 Four of the five departments that we audited have satisfactory controls over the management of grants and contributions. Indian and Northern Affairs Canada needs to make significant improvements.

6.71 The departments and the Secretariat need to streamline the management of grants and contributions and maintain an appropriate balance between risk and control.

About the Audit

Objectives

The objective of our audit was to determine the extent to which the government has ensured effective government-wide management and control over the spending of public money through voted grants and contributions. To do this we assessed the design, implementation, and effectiveness of control frameworks for grants and contributions, and how the government responded to our past recommendations and those of the Standing Committee on Public Accounts.

Scope and approach

Our audit was designed to assess whether the government has a complete and clear policy framework and whether it oversees effective management of grants and contributions in a way that is sensitive to risks, complexity, and accountability for results.

We assessed

- the nature and extent of monitoring done by the Treasury Board Secretariat, including the status of the required renewal of all grant and contribution programs, which were to take place no later than 31 March 2005;
- whether approved terms and conditions of renewed grant and contribution programs provide a basis for adequate control and risk management;
- the effectiveness of departmental management and control of grant and contribution programs; and
- whether these programs adequately address the design stipulated in their approved Treasury Board submissions.

Our audit covered the period between 1 April 2003 and 31 March 2005.

The departments and agencies included in the audit were

- Canadian Heritage,
- Human Resources and Skills Development Canada,
- Indian and Northern Affairs Canada,
- Public Health Agency of Canada,
- Social Sciences and Humanities Research Council of Canada, and
- Treasury Board Secretariat.

The summary level criteria were based upon the Treasury Board's Policy on Transfer Payments.

Criteria

We expected that the Treasury Board Secretariat would

- set a complete and clear policy for departments to follow to manage grants and contributions;
- ensure that the terms and conditions of approved grant and contribution programs provide effective control;

- provide appropriate direction and guidance to departments to manage grants and contributions;
- use a risk management approach to its responsibilities to monitor the use of grants and contributions;
- compile sufficient information on departmental operations to assess the effectiveness of the Policy on Transfer Payments and whether its objectives are being met; and
- identify any systemic problems in managing and controlling grant and contribution programs, and take appropriate remedial action and assess the effectiveness of that action.

We expected that departments would

- design and implement effective financial and program controls;
- exercise due diligence in the selection and approval of recipients of grants and contributions;
- comply with authorities;
- develop a results-based management and accountability framework that provides for appropriate measurement and reporting of results and evaluation criteria to be used in assessing the effectiveness of the programs;
- establish the management and program capacity necessary to effectively deliver and administer their programs;
- exercise due diligence in monitoring recipients' use of contributions, including a risk-based framework for audit;
- ensure that proper program, accounting, and other relevant records and documents are maintained;
- ensure that the amount of each transfer payment is appropriate, taking into consideration stacking of assistance and eligible project costs;
- ensure that payments were made according to the Policy on Transfer Payments and the *Financial Administration Act*; and
- recover amounts due to the Crown, as appropriate.

Audit work completed

Audit work for this chapter was substantially completed on 30 September 2005.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 6. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
The role of the Treasury Board Secretariat	
6.24 The Treasury Board Secretariat should ensure that • the types of transfer payments available to departments meet the variety of needs for their programs, • the definitions of transfer payment types and their associated requirements are consistent, and • guidance is provided on how to select transfer payment types so that selections are consistent across departments. (6.21–6.23)	**The Treasury Board Secretariat's response.** Agreed. The Treasury Board Secretariat is pleased that the Office of the Auditor General has recognized that the existing policy and guidance, as well as the review and approval by the Treasury Board of program terms and conditions, provides a basis for effective control of transfer payments. Further improvements are being considered through the policy review and other guidance to enable consistent approaches across government that allow for a better balance between risks, control, and accountability for results. The Treasury Board Secretariat is committed to incorporating departmental, central agency, and stakeholder experiences into policy revision. In this regard, it hopes to increase the number of transfer payment options available to departments, thereby responding to their various needs while continuing to allow for flexibility as further needs arise. The Treasury Board Secretariat will update the accompanying guidance material to facilitate consistent approaches across government, including the selection of suitable transfer payment instruments. The implementation strategy being considered for the proposed revisions to the Policy on Transfer Payments will facilitate an integrated approach to sharing knowledge and best practices through training programs and interdepartmental activities.

Recommendation	Department's response
6.31 The Treasury Board Secretariat should establish and co-ordinate an interdepartmental working group on transfer payments to discuss concerns about applying the Policy on Transfer Payments and share best practices for managing grants and contributions. (6.27–6.30)	**The Treasury Board Secretariat's response.** Agreed. Interdepartmental initiatives that focus on exchange of knowledge and best practices in transfer payments are key success factors. Results of departmental consultations in the review of the Policy on Transfer Payments reveal that there is strong support for the re-establishment of such an interdepartmental working group. The Treasury Board Secretariat is including such an initiative as part of its planned implementation strategy for the proposed revisions to the Policy on Transfer Payments.
6.34 The Treasury Board Secretariat should continue to monitor the work of the Task Force on Community Investment and amend the Policy on Transfer Payments and guidance for transfer payments as necessary. (6.32–6.33)	**The Treasury Board Secretariat's response.** The Treasury Board Secretariat is committed to continuing its engagement with the Task Force on Community Investments and to building on the lead role it played in the development of the Voluntary Sector Initiative guidance publication, *A Code of Good Practice on Funding*. The Secretariat will continue to be involved both at the Steering Committee and working levels so as to better understand the needs of the voluntary sector. This understanding will feed into ongoing processes related to improvements to the Policy on Transfer Payments, and to the accompanying directives, guidance materials, and practices.
The role of departments and agencies	
6.54 Indian and Northern Affairs Canada should strengthen its grant and contribution management controls by • preparing a risk-assessment of recipients to determine the appropriate frequency and depth of monitoring and reporting, • completing the development and implementation of its automated management system for grants and contributions, and • providing necessary training to its program officers. (6.38–6.53)	**Indian and Northern Affairs Canada's response.** Indian and Northern Affairs Canada agrees with this recommendation. The Department recognizes the importance of the issues raised in this chapter and is committed to improving and strengthening its grants and contributions management processes. The development of a new First Nations and Inuit Transfer Payment System is the most important initiative currently under way, which will further improve and strengthen management practices. The Office of the Auditor General is supportive of this automated grants and contributions management system. Indian and Northern Affairs Canada recognizes and fully supports the importance of providing ongoing training to its staff. It also recognizes the need to adopt a risk-based approach to manage all grants and contributions, and determine eligibility and the appropriate level of monitoring and reporting.

Recommendation	Department's response
	The Department will continue to work closely with the Treasury Board Secretariat to develop a Policy on Transfer Payments that meets both departmental and recipient needs.
6.64 The government should co-ordinate and implement a single audit process for the recipients of transfer payments from federal programs. (6.56–6.63)	**The Treasury Board Secretariat's response.** Agreed. There is a need to reduce the audit burden placed on recipients while ensuring an appropriate level of control and accountability. A coordinated single recipient audit regime will be pursued to the extent possible. The Treasury Board Secretariat's commitment to improving management aims to better promote horizontal management and the integration of activities that will assist departments to focus on exchanges of knowledge and promotion of best practices. Program design and administration must be client focused including, wherever possible, common and integrated recipient audit requirements. Interdepartmental initiatives will be undertaken to facilitate implementation and to highlight best practices in areas of streamlined recipient auditing.
6.68 The Treasury Board Secretariat and departments, while balancing risk, control, and accountability for results, should streamline the application, reporting, and audit requirements for grants and contributions in ways that would reduce the administrative burden on recipients. (6.65–6.67)	**The Treasury Board Secretariat's response.** Agreed. The administrative burden on recipients must be reduced through streamlined application, reporting and audit requirements to the extent possible. The proposed revisions to the Policy on Transfer Payments and to the supporting guidance material will provide best practices on how to streamline application, reporting, evaluation, and audit requirements. Interdepartmental initiatives will enable the sharing of knowledge and best practices between departments on how to reduce the administrative burden. Guidance will also be provided on reducing the administrative burden on the recipient population. Periodic assessments of departmental transfer payment programs will address the extent to which streamlined application, reporting, and audit requirements are being implemented, which would in turn reduce the administrative burden on recipients.

Chapter

7

Acquisition of Leased Office Space

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the [illegible] we also draw upon the standards and practices of other disciplines.

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Acquisition of Leased Office Space

Main Points

What we examined

Public Works and Government Services Canada (PWGSC) is responsible for providing office accommodation to some 100 federal departments and agencies. In 2002, we audited the Department and examined its strategic planning, its management practices, and its analysis of options for providing office space.

To assess the progress made since then, we audited the Department's analysis of options for providing office space and the steps it has taken to strengthen the integrity and availability of information. We also examined a sample of lease transactions to see whether PWGSC had fully considered all options—including construction, lease-purchase, purchase, and lease—in order to identify the most cost-effective office accommodation solution in each case. Finally, we assessed the risk management practices of the Real Property Branch, including the way it is managing the risks associated with the federal government's objective of reducing the cost of real property management by about $1 billion over the next five years. We did not assess progress made by the Department in performance measurement, investment planning, and reporting to Parliament. These areas are under review by the Department, with a view to adopting its new business strategies.

Why it's important

PWGSC manages 6.6 million square metres of rental space and spends $3 billion annually to manage real property. The Department handles some 500 lease transactions a year. It needs complete, accurate, and timely information to support good decision making, strategic management, and risk management. The Department's commitment to achieve the government's cost-reduction goal makes strong management practices even more vital for the Branch.

What we found

- PWGSC has made unsatisfactory progress in response to the recommendations that we followed up on this audit. While the Department has made satisfactory progress in analyzing the long-term cost of long-term options, there are still gaps in its financial and management information systems. These gaps may pose significant risks to the Department in achieving the government's cost-savings target by 2010.

- Responsibility for decisions affecting the cost of office accommodation is shared among PWGSC, client departments, and the Treasury Board. The Treasury Board must approve decisions for those projects that exceed the delegated authority of the Minister of PWGSC. As a result of this shared responsibility and the use of funding mechanisms that are not consistent with financial analysis, it is sometimes difficult for PWGSC to impose and adhere to its office accommodation standards pertaining to quality and square metres per person. In addition, we noted instances where the Department did not enforce its standards.
- The financial analysis used by the Department to assess accommodation options considers the cost of a lease over its life, while the government's funding mechanisms focus on annual cash spending. We noted cases where a lack of capital funding prevented the selection of the recommended option.
- Although PWGSC has taken some first steps to identify risks in its management of real property, it has not yet fully incorporated risk management into its day-to-day operations. Its risk management systems do not deal adequately with corporate-wide risks that could jeopardize its cost-savings objective.

The Department and the Treasury Board Secretariat have responded. Public Works and Government Services Canada and the Treasury Board Secretariat are in general agreement with our recommendations. Their responses are included throughout the chapter.

Introduction

Responsibilities of Public Works and Government Services Canada

7.1 Public Works and Government Services Canada (PWGSC) provides a range of services to client departments to help them achieve their program objectives. These services include securing office space.

7.2 The Department's Real Property Branch manages office accommodation in some 1,900 locations across Canada. About 250 of these sites are Crown-owned office buildings. The Branch handles about 500 lease transactions a year.

7.3 Of the 6.6 million square metres of space that the Branch manages, 52 percent is Crown-owned, 41 percent is leased, and 7 percent is **lease-purchased** accommodation. Offices comprise 5.7 million square metres of this space. The remaining 0.9 million square metres consist of laboratories, warehouses, and other specialized facilities. The Branch manages its existing inventory and acquires new space by constructing new buildings, acquiring existing facilities, and leasing.

Lease-purchase—A lease wherein the lessee of the real property has the right or option to purchase the property upon termination of the lease contract.

7.4 The Department's real property business line employs 4,100 employees and manages an annual business volume of about $3 billion.

7.5 Providing office accommodation for the federal public service is a complex and difficult task. The responsibilities for office accommodation costs are shared among PWGSC, client departments, and the Treasury Board (Exhibit 7.1).

7.6 The Real Property Branch provides a mandatory service—the provision of office space—to client departments. This service is financed through PWGSC's annual appropriation. The Branch also provides optional services, such as architectural and engineering services, to departments for a fee. Individual departments pay for those services from their own budgets. The Branch maintains a **revolving fund** to manage the revenues and expenses associated with these optional services.

Revolving fund—A means by which Parliament provides continuing authorization for an operation that is funded completely by users, or partly by users and partly by subsidization (the latter usually taking the form of an annual appropriation).

7.7 The Branch's share of the Department's appropriation covers basic building costs in Crown-owned assets. These costs relate to buildings' operation, maintenance, repair, and capital improvement, throughout the buildings' life cycles. Appropriation funding also covers the leasing and **fit-up costs** of leased assets. Clients pay for their own equipment and furniture.

Fit-up costs—Expenses incurred to prepare space for initial occupancy or to alter space previously occupied by another tenant. These costs include, but are not limited to, those for interior walls, doors, windows, partitions, washrooms, basic wiring for power and telephone outlets, and related changes to basic building systems.

Exhibit 7.1 Responsibilities for office accommodation costs

Public Works and Government Services Canada

- Selecting accommodation alternatives that balance client requirements with principles of competition, prudence, probity, and value for money
- Developing accommodation strategies, including establishing and enforcing the standards for allowable square metres per person and quality of space

Client departments

- Certifying demand for office space, based on operational and functional requirements
- Providing information on the forecasted number of employees

Treasury Board

- Approving lease transactions that exceed $30 million
- Establishing the administrative policy framework of government, including real property policies

Treasury Board Secretariat

- Advising on real property plans and expenditures of all departments and individual real property projects and contracts
- Reviewing the use of real property from a central perspective

Source: Public Works and Government Services Canada—Framework for Office Accommodation and Accommodation Services; the Treasury Board—Real Property Management Framework

7.8 The Treasury Board Use of Real Property Facilities Policy requests that PWGSC provide facilities within established standards to meet the operational needs of the user departments. PWGSC's Framework for Office Accommodation and Accommodation Services limits the quantity of space that the Branch will provide to client departments. As well, PWGSC will only fund office improvements according to the established standards. If client departments want extra space or have additional requirements, they must pay for them from their own budgets.

Initiatives since 2002 to transform real property management

7.9 PWGSC began a renewal project shortly after our 2002 audit. The project was directed at modernizing the way the Department conducted its business. Since 2003, several events have added momentum to that renewal effort. Principally, the federal government's Expenditure Review Committee has identified the real property business line as the source of about $1 billion in savings over the next five years. The Department's strategic initiative related to this financial goal is referred to as **The Way Forward**.

The Way Forward—The term used by Public Works and Government Services Canada to describe its department-wide "strategic initiative whose objective is to find innovative ways to deliver services smarter, faster, and at a reduced cost, and to improve how the Government of Canada does business."

7.10 PWGSC is to realize those savings primarily by spending less. For example, the Real Property Branch plans to reduce clients' average use of space from its current level of 21.6 square metres per employee to 18 square metres, as provided by the Department's Framework for Office Accommodation and Accommodation Services. The Department intends to apply its **fit-up standards** consistently to all departments. These measures are expected to reduce accommodation costs by $500 million over the next five years. The Branch also plans to use its "holdings more efficiently by consolidating the needs of federal departments" and by "improving the management of its lease portfolio." The Department sets out in its Report on Plans and Priorities that "improved portfolio management and leasing strategies will help achieve expenditure reductions approaching $300 million" over five years. Other savings, from reducing overhead costs, are expected to reduce costs by about $175 million.

Fit-up standards—Standards applied to prepare space for initial occupancy or to alter space previously occupied by another tenant. The approach of Public Works and Government Services Canada to fit-up is guided by the Department's Framework for Office Accommodation and Accommodation Services. The Framework covers standards for fit-up components, support spaces, and funding accountability.

Focus of the audit

7.11 The focus of our audit was to assess the progress that PWGSC had made in responding to our 2002 audit observations and recommendations. In our 2002 audit, one of our main findings was that the Department needed to strengthen its management information systems in order to provide managers with key operational and financial information.

7.12 In our current audit, we also assessed whether the Department had adequately incorporated principles of risk management into its strategic plan to acquire leased office space. In addition, we assessed the extent to which the Real Property Branch identified and managed key risks that could affect its ability to achieve its strategic objectives.

7.13 Finally, we assessed whether PWGSC had fully considered its long-term options for providing accommodation by examining a sample of high-value lease transactions. More details on the audit objective, scope, approach, and criteria are in **About the Audit** at the end of the chapter.

Observations and Recommendations

Responsibility for costs of office space

Shared responsibility for costs of office space impedes efforts to reduce costs

7.14 PWGSC, client departments, and the Treasury Board share responsibility and accountability for the cost of office accommodation. PWGSC tries to provide appropriate office accommodation to meet the needs of client departments. The Real Property Branch identifies options that, depending on a client's needs, may include short-term leases or longer-term alternatives. These options include Crown-owned space, lease-purchase arrangements, and long-term leases. The most cost-effective option may involve moving a client department's staff to a different building—or it could mean leaving them where they are. We expected that PWGSC and departments would work co-operatively to select the most cost-effective option in acquiring office accommodation and preparing it for occupancy.

7.15 A combination of decisions by PWGSC, client departments, and the Treasury Board affects the cost-effectiveness of office accommodation options. This shared responsibility for the cost of office accommodation can result in project delays and/or additional costs. Although the Real Property Branch has the authority under the Treasury Board Real Property Management Framework Policy to impose accommodation solutions, it has not always done so. Exhibit 7.2 provides an example of how a client's request and PWGSC's decision not to enforce standards have affected the cost of accommodation.

7.16 PWGSC's real property management framework specifies that office space should be allocated at a standard rate of 18 square metres per full-time employee. According to a September 2004 PWGSC report, the use of office space averaged about 21.6 square metres per person. The report notes that because "some client departments view office accommodation as a 'free good,' they have little incentive to economize on the size of their space." The Department states that the current use of space has now decreased to 20.4 square metres per person. The ability of clients to choose more costly alternatives could undermine PWGSC's objective of obtaining the best value.

7.17 The Department states in its reports on plans and priorities (RPP) that it "will more consistently apply standards and work with departments toward reducing the average space use to 18 square metres per employee, leading to an overall space reduction of 450,000 square metres." The Department also notes that it "will more consistently apply fit-up standards to office space." It will be important

Exhibit 7.2 A client's request and a decision by Public Works and Government Services Canada not to enforce standards results in additional cost of $4.6 million

800 Place Victoria, Montréal, Quebec

The Economic Development Agency of Canada for the Regions of Quebec had been a tenant in Place Victoria for many years. The Agency's lease at Place Victoria was to expire in 2003. In 2001, the Agency worked with Public Works and Government Services Canada (PWGSC) to initiate a competitive tendering process to obtain the required accommodation for the Agency. The Agency's landlord at Place Victoria bid on the tender and was ranked fourth in the bid evaluation process. Two weeks after the tendering process had closed and the winning bidder had been selected, the Secretary of State for the Agency sent a letter to the Minister of PWGSC asking him to renew the lease at Place Victoria. The Minister of PWGSC approved the renewal of the lease at Place Victoria.

Despite the fact that PWGSC's guidelines require an economic advantage to the Crown to exist in order to justify a direct non-competitive negotiation of a lease and despite the absence of any economic advantage to the Crown, PWGSC entered into direct negotiations to renew the lease with the landlord at Place Victoria.

Because of the potential for recourse from the winning bidder in the tendering process, PWGSC also entered into a lease with the lowest bidder, even though it did not have a tenant for the space. Renewing the lease at Place Victoria cost $2.5 million more than the winning bid in the tendering process, and PWGSC paid $2.1 million in unproductive rent to that bidder while trying to locate tenants for the additional space. Some space in that building is still unoccupied.

The Agency's request not to move, combined with the lack of adherence to established guidelines, has cost taxpayers an additional $4.6 million.

for the Department to enforce its standards to achieve the savings objectives of the Way Forward initiative. This will be a particular challenge given that, as reported in its RPP, "the amount of office space allocated per employee is greater in the federal government than it is in many areas of the private sector."

7.18 In some of the lease transactions we examined, we found instances where departments paid funds from their own budgets for fit-ups that cost more than government standards allowed. This practice has two consequences. First, it adds to the total cost of accommodation. Second, it hinders accountability because it obscures the full cost of leased office space, making it difficult to identify the full cost of office accommodation and report it to Parliament.

7.19 In our view, the shared responsibility for decisions that affect the cost of office accommodation impedes the federal government's efforts to reduce costs in this area. If the government is to meet its expenditure reduction target, PWGSC, client departments, and the Treasury Board, through its oversight role, will have to co-operate to reduce costs. Further, PWGSC will have to enforce the government's established standards.

7.20 **Recommendation.** In its departmental performance report, Public Works and Government Services Canada should include progress against projected savings and the cost of those instances where the most cost-effective accommodation option was either not accepted or not enforced.

Public Works and Government Services Canada's response. Shared responsibilities inevitably give rise to some inefficiency. There is now a renewed effort, supported by the Treasury Board Secretariat, to enforce standards for space and fit-up, and this is resulting in savings to the government. We will work with the Secretariat to include more reporting to Parliament on this issue.

Assessing options

PWGSC adequately analyzes the costs of accommodation options

7.21 In our 2002 audit, we reported that PWGSC needed to strengthen its consideration of long-term options. We found that the Department had made satisfactory progress in this regard (Exhibit 7.3).

Exhibit 7.3 Progress in addressing our recommendation from our 2002 Report

Recommendation	Progress
The Real Property Services Branch should review its methods of options analysis to ensure, where practical, that long-term options are considered fully. (December 2002 Report, Chapter 8, paragraph 8.61)	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.22 In our current audit, we noted that in assessing the options for providing accommodation to departments, PWGSC is required, as per the Real Property Framework and Processes for Leasing, to prepare an Investment Analysis Report for each transaction that it completes. This report analyzes the full cost of each option over the expected life of the requirement—often 15 to 25 years. The options generally include construction, lease-purchase, purchase, and lease.

Funding mechanisms can preclude selection of the most cost-effective option

7.23 We expected that the government would select the most cost-effective option in meeting the long-term requirements of client departments. We also expected that funding mechanisms would help

to select the most cost-effective option. However, this was not always the case.

7.24 The financial analysis of an option considers the full cost of that option over its estimated useful life, while funding decisions consider the cash expenditure at the time of the transaction. We noted that the government does not always select the most cost-effective alternative to meet the accommodation requirements of the client department (Exhibit 7.4). This occurs because a decision on funding accommodation transactions focusses on the availability of cash-based funding rather than on accrual-based funding (see paragraph 7.25). This can result in additional cost to taxpayers.

7.25 The Treasury Board Secretariat is studying the implementation of accrual-based budgeting and appropriations, and its impact at the departmental level. If a complete accrual approach to budgeting and appropriation were adopted, the accrual method would recognize budgeting and funding for a transaction when the underlying economic event is expected to occur, rather than when cash is expected to be paid. The objective of the accrual method is to ensure that transactions are budgeted and funded in the periods in which they occur, rather than in the periods in which the payment is made. For example, with accrual-based budgeting and appropriations, the expenses related to the purchase of a building would be spread over the life cycle of the asset. Presently, with cash-based budgeting and appropriations, the government funds the full expenditure against its cash appropriation in the year that it acquires the building, even though it will use the asset over a number of years.

Exhibit 7.4 Funding mechanisms do not always support selection of the most cost-effective option

55 Bay Street, Hamilton, Ontario

The Investment Analysis Report that Public Works and Government Services Canada (PWGSC) prepared for this transaction recommended leasing and exercising a purchase option in the second year of the lease. The Treasury Board would not approve the purchase; rather, it approved an alternative to lease the property for 15 years—the most expensive option in the Investment Analysis Report. Choosing this option may cost the Crown an additional $13 million.

7575 8th Street, Calgary, Alberta

PWGSC officials prepared an Investment Analysis Report that determined the least expensive option was for the Crown to purchase the building for $27 million. However, in the absence of the necessary capital funding, PWGSC recommended the second-best option, at $31.4 million. This option recommended leasing the building for five years, with an option to purchase in year six. Selecting the second-best option may cost the Crown an additional $4.4 million.

7.26 **Recommendation.** The Treasury Board Secretariat should develop a plan for departments to use financial information based on an accrual-based budgeting and appropriations approach in planning, budgeting, and reporting.

The Treasury Board Secretariat's response. The Treasury Board Secretariat agrees that there are limitations associated with annual capital appropriations. The Secretariat is addressing the issues through two initiatives.

The first initiative, as mentioned in the chapter, is the engagement of an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government.

The Treasury Board Secretariat will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of the implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The government can approve changes to the budgeting process; however, Parliament must approve changes to appropriations.

The second initiative is a pilot project under development for non-lapsing capital appropriations. The pilot project proposes allowing up to three departments to carry forward unexpended asset funds from one fiscal year to the next, beginning as soon as next year. This will provide departmental managers with more flexibility in planning their operations and remove the current short-term focus of the planning horizon for asset and associated resources.

The absence of accrual appropriation has long-term financial implications

7.27 The financial impact of entering into a series of short-term leases to meet long-term space needs can be significant due to the incongruities between the funding methods and the financial analysis of the cost of accommodation. In the sample of leases that we audited, we noted instances where a series of short-term leases were used to meet long-term accommodation needs, even though the financial analysis prepared by PWGSC indicated that Crown ownership would have been more cost-effective. In these cases, the federal government, at the end of its current lease obligations, will have rented the premises

for more than 40 years. These cases illustrate the long-term effect that can occur when funding methods do not facilitate the selection of the most cost-effective options (Exhibit 7.5).

Exhibit 7.5 Selection of accommodation options results in additional costs

Centennial Towers, Ottawa, Ontario

Centennial Towers was built in 1965. The federal government has been its primary tenant for all but five of the subsequent years. Beginning in 1983, Public Works and Government Services Canada (PWGSC) entered into a series of 10-year leases. The current lease runs from 2003 through 2013. In its most recent lease renewal, the Department's analysis indicated that the present value of the cost of accommodation was $261 million, or $81 million more than the most cost-effective alternative that it had identified in 2001 (Crown-purchase option). The departmental calculations were based on a 25-year time horizon.

Jean Edmonds Towers, Ottawa, Ontario

Jean Edmonds Towers was constructed in 1974. Since then, PWGSC has entered into a series of leases. The federal government has been the sole tenant and is committed to leasing the space through 2015. In its most recent lease renewal, the present value of the cost of accommodation was $158 million, or $12.5 million greater than the least-cost option identified in the financial analysis. The Department's calculations were based on a 10-year time horizon.

7.28 Recommendation. The Treasury Board Secretariat and Public Works and Government Services Canada should ensure that funding methods support the selection of the most cost-effective option that meets the long-term accommodation requirements.

Public Works and Government Services Canada's response. We are pleased that the Auditor General has found that Public Works and Government Services Canada adequately analyzes the cost of accommodation options before decisions are made. The issue of how funding mechanisms affect rational decision making is an important one. We agree with the recommendation and will continue to work with the Treasury Board Secretariat and other parties to ensure that, wherever possible, funding mechanisms support the most cost-effective solution that meets the long-term accommodation requirements. We recognize that this may take some time to resolve since it represents a fundamental change to government accounting and budgeting.

The Treasury Board Secretariat's response. The Treasury Board Secretariat recognizes that, in some instances, current funding mechanisms may limit the ability of Public Works and Government Services Canada (PWGSC) to select the most cost-effective option for long-term accommodation requirements.

The Capital Asset Review (CAR), conducted in 2004 as one of the federal government's expenditure management reviews, raised this same issue in the broader context of capital asset management. Responding to the CAR, the Secretariat is considering a more flexible funding mechanism, known as non-lapsing capital appropriations, and it has developed a pilot program with three departments to confirm the anticipated benefits of this option.

Subject to this experience, the Secretariat will consider expanding the pilots to other departments and agencies, including PWGSC, providing they meet the participation criteria. The Secretariat will keep departments and agencies, including PWGSC, informed of progress in this area.

Irrespective of the potential change toward non-lapsing capital appropriations, PWGSC is responsible for managing its investment program, within existing reference levels. This must be done in accordance with key Treasury Board policies related to assets management, namely the Policy on Long-term Capital Plans, the Project Management Policy, and the Real Property Policy Suite, including the Treasury Board Real Property Investment Policy, all of which support least-cost best-value decisions.

Management information

Problems with management information systems continue

7.29 In 2002 we reported that PWGSC needed to strengthen both the integrity and availability of information to support the management of the acquisition of office space. In our current audit, we expected the Real Property Branch to have complete and accurate management and financial information to support decision making and the management of its real property portfolio.

7.30 A number of documents we reviewed indicated that the Department had not fully addressed our previous observations about weaknesses in its management information systems. PWGSC's 2004 Report on Real Property Renewal, its draft 2005 National Portfolio Plan, and the government's 2003 Report on Expenditure Management Review all noted problems concerning a lack of information for management purposes. For example, the Report on Expenditure Management Review reported that managers are reluctant to rely on the Department's existing information systems. The report also noted that the Department lacked basic information about the costs that client departments had incurred either for extra space beyond what was allocated in the policy (Framework for Office Accommodation and Accommodation Services) or for higher standards of fit-up.

7.31 The Report on Real Property Renewal acknowledged that the Department's information systems are cumbersome and expensive. It also noted that the Department spends about $50 million on these systems each year, yet the systems do not provide the information or allow the input that would enable managers to make well-informed decisions about managing the real property portfolio. According to the renewal report, PWGSC cannot accurately and routinely report the full costs of its real property operations. The Department informs us that these systems are only one source of information; however, it agrees that its many systems need to be overhauled and integrated.

7.32 The fit-up costs for the leased portfolio of buildings are a significant component of the total cost of providing office space. Thus, we expected that the Department would be able to provide us with the budgeted costs, with any revisions to original budgets, and actual expenditures for the fit-up costs for our sample of leases. We asked for this information to see whether original budgets had changed and to determine the reasons for any changes. Departmental officials advised us that this information was not readily available and would require extensive manual intervention to accumulate.

7.33 This persistent difficulty in aggregating financial information is even more important now, given that the Department is obliged, under its Way Forward initiative, to generate significant savings in managing the real property business line.

Better information is required to manage the portfolio strategically

7.34 Departmental documents indicate that the Real Property Branch has much work to do to modify its information systems. Currently, PWGSC's numerous systems operate in "silos"—that is, they do not share information. Moreover, they are not designed to capture certain information that will be essential to managing the portfolio on a strategic basis.

Some improvements have been made

7.35 We found that PWGSC is taking action to address its management information requirements. In March 2004, the Department established a Governance Framework for Information Management and Information Technology. It has also started a project to improve data integrity. These initiatives are important first steps. Nevertheless, the overall progress in addressing our previous recommendations is unsatisfactory (Exhibit 7.6).

Exhibit 7.6 Progress in addressing our recommendations from our 2002 Report

Recommendation	Progress
The Real Property Services Branch should introduce more discipline and rigour into its collection and use of information, including demand information, in managing the acquisition of office space. It should ensure that the required reports are available to decision makers for each transaction and that decisions are fully documented. (December 2002 Report, Chapter 8, paragraph 8.71)	
The Branch should develop an accurate management information system to ensure the completeness and accuracy of its financial and operational information. (December 2002 Report, Chapter 8, paragraph 8.81)	

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

7.36 We noted that the Department initiated a process to revise the way it manages its real property portfolio. A recently issued Request for Proposal seeks advice on the best business model for all aspects of its real property operations. The Department has indicated that it will upgrade its information systems after policy decisions and the related business model have been finalized.

7.37 **Recommendation.** Public Works and Government Services Canada should continue to improve the availability, accessibility, and reliability of information to support sound decision making for real property investments.

Public Works and Government Services Canada's response. We agree with this recommendation. While current systems enable Public Works and Government Services Canada to control costs incurred by the Department on individual projects, we recognize that our systems are cumbersome for overall management and acknowledge that improvements remain to be made.

Managing real property risks

7.38 The risk management component of our audit assessed the Real Property Branch's practices to see how it managed risks in acquiring leased office space throughout the life cycle of the lease. We expected that the Department would have identified and assessed the risks of the Branch and established and documented appropriate risk mitigation procedures to meet the requirements of

- the Treasury Board Secretariat's Integrated Risk Management Framework, and

- the risk management specifications of the Treasury Board Secretariat's Management Accountability Framework.

7.39 In examining the Department's risk management activities, we also assessed the extent to which the Branch identified and managed key risks that could affect the ability to achieve the strategic objectives of its Way Forward initiative.

A variety of risks can affect leasing

7.40 There are several types of risks that can affect leasing (Exhibit 7.7). Accordingly, we expected to find a formal and consistent process in the Department for identifying and managing the risks that can arise in leasing decisions, which may span up to 60 months from inception to occupancy. However, we did not find such a process.

Exhibit 7.7 Risks that can affect leases

Risks can occur throughout the life cycle of a lease—from planning, to fit-up, to moving staff into their offices. The following are examples of typical risks that can arise at various points in a leasing transaction.

Client-related risks. A client department may change its requirements for the amount and type of space and its fit-up specifications. If this situation arises, the change may result in delays and increased costs.

Legal risks. Potential legal risks may arise in the tendering process of Public Works and Government Services Canada (PWGSC). Examples of these risks include changing the bid process midstream or accepting an unsolicited proposal from a bidder.

Contractor-related risks. Part way through a project, a general contractor may not be able to finish a building because of bankruptcy. The attendant risks include cost overruns, delays, and potential liability for the Crown.

Landlord-related risks. At the end of a lease, a landlord of an occupied building may not be willing to renegotiate at favourable terms or may not want to modify buildings to meet PWGSC's project schedule. These risks may result in increased costs and delays.

Internal risks. Many PWGSC staff are involved in leasing projects, and numerous changes to projects can occur. A lack of co-operation among all involved can result in delays and cost overruns.

Risk management strategies lack key information

7.41 A department's ability to manage risk on an organization-wide basis increases its ability to achieve its objectives. Integrated risk management helps departments better manage their programs and contributes to achieving better value for money, thereby helping to make the public service more effective.

7.42 PWGSC has begun to develop an integrated risk management framework. This includes establishing some preliminary procedures and identifying high-level risks associated with the Real Property Branch.

7.43 The Department's identification of risks has highlighted the need to manage such ongoing risks as balancing organizational change with ongoing priorities and human resource challenges. These risks, if not addressed effectively, could prevent the Department from achieving its goal of reducing accommodation costs of the real property business line.

"Regional and community based investment strategies are part of the Real Property National Investment Strategy (NIS) of Public Works and Government Services Canada. The Strategy provides the planning framework for all of the Department's investments in real property on behalf of its clients, tenants, and the Government of Canada. The regional and community based investment strategies provide essential input to NIS and are also key mechanisms for its delivery."

Public Works and Government Services Canada, *Real Property Solutions*

7.44 We reviewed **regional investment strategies** to assess the nature and extent of risk information included in them. We noted that **community-based investment strategies** developed to address accommodation requirements within a region do not always contain information on the risks associated with the strategies. For example, an integral part of the Vancouver Community-Based Investment Strategy was to build office space in the downtown core. The strategy did not include an analysis of the risks associated with the government neither owning land nor having an option to acquire land. As well, there were no contingency plans to implement if space could not be constructed.

Risk information in leasing transactions needs to be documented

7.45 PWGSC staff engaged in the leasing process have considerable experience in leasing office space. However, we noted that in their negotiation of lease transactions, staff do not always document the nature of the risks and the action taken to manage them. As a result, senior managers do not have a complete view of leasing-related risks that leasing officers are dealing with. The Branch had no documented aggregate view of the risks associated with either individual leases or leases across their life cycle, to correspond with the Treasury Board Secretariat's Integrated Risk Management Framework.

7.46 With the exception of the risk posed by scheduling delays, which the Branch identifies quarterly in the Planned Leasing Action Report, staff do not document information that would give senior managers a view of the leasing-related risks of the entire real property portfolio. For example, the Branch needs to identify and document risks associated with specific clients, landlords, and owners of buildings. Such information is critical if the Department is to manage its leasing activity on a portfolio basis.

7.47 The Integrated Risk Management Framework encourages departments to identify, address, and monitor risks across an organization as a key component of effective management.

Risk management training is needed

7.48 Key components of integrated risk management are developing and delivering appropriate training and implementing risk management tools. The Real Property Branch has developed a training program and an automated tool to help staff identify and manage risk over the life of a lease. Both the program and the tool were well designed and include the elements needed to comply with the Treasury Board Secretariat's Integrated Risk Management Policy.

7.49 However, neither the training program nor the automated tool has been implemented to date. We noted that PWGSC's Client Accommodation Service advisors have received only limited formal training in risk management. We are concerned about this because those administrators, who work closely with client departments that lease space, are well-positioned to contribute to managing risk. However, we found no evidence that they play a formal or lead role in managing and co-ordinating risk information. Moreover, the number of administrators is declining, as are other resources that could improve risk management in the Department.

Risk information is needed to analyze options

7.50 The Investment Analysis Report is a major planning tool that helps the Branch decide how it will acquire office space—for example, by leasing, building, buying, or entering a lease-purchase agreement. A leasing project's planning phase can span up to five years, particularly for major, complex leases. We expected that these reports would be complete and would be updated throughout this phase to ensure that emerging risks are taken into account.

7.51 We found that once reports were developed, they were rarely updated to reflect changes in related risks. This creates a significant risk that the ultimate investment decision may not be based on the most current information. We understand that the Department is reviewing the Investment Analysis Report's template and design and will incorporate guidance about the need for continuous risk management.

7.52 We also found that the Branch does not include an analysis of the risks associated with each option in the report (whether to lease, build, buy, or negotiate a lease-purchase agreement). Therefore, decision makers are not weighing the relative risks when deciding which option to pursue.

7.53 **Recommendation.** Public Works and Government Services Canada should

- continue its efforts to develop guidance and to implement continuous risk management as part of the process for acquiring office accommodation, and
- provide staff with the necessary training in risk management.

Public Works and Government Services Canada's response. We agree with this recommendation. Public Works and Government Services Canada has made considerable progress in this area and will continue to do so. In areas of great importance, such as managing the risk related to achieving our five-year cumulative savings target of $150 million from leasing operations, we have implemented compensating controls. These controls include the establishment of a Strategic Transformation Branch to monitor and control achievement of our goals. In addition to implementing more rigour in its leasing practices and providing ongoing training to its staff, the Real Property Branch has implemented a Lease Savings Tracking System to monitor net transaction savings on a monthly basis. As a result of these measures, we have already achieved, as of 1 January 2006, more than half of our five-year cumulative savings target of $150 million, and will continue to monitor our progress carefully.

Conclusion

7.54 Public Works and Government Services Canada has made unsatisfactory progress in responding to the recommendations we made in 2002. In 2005, we found that many of the Department's practices did not allow it to manage the costs of its leasing projects effectively. If the Department is to meet its commitment to reduce the costs of providing office space over the next five years, it must manage its leasing projects strategically, across the entire portfolio. However, the Department will have difficulty doing so because the basic information that managers need to make critical strategic decisions does not exist, is inadequate, or is difficult to access. In addition, the government must implement accrual appropriations so that funding mechanisms support the selection of the most cost-effective accommodation options.

7.55 The federal government needs to make fundamental changes in its accountability structure for providing office space. Currently, the shared responsibility among PWGSC, client departments, and the

Treasury Board makes it difficult for PWGSC to impose and adhere to government-wide standards for the quantity and quality of office accommodation. The Department has not always enforced those standards, which has resulted in additional costs for taxpayers. Clearly defined accountability and support from the Treasury Board for enforcing these standards should help PWGSC to meet its cost-saving objectives. It is important that the government move quickly to implement accrual-based appropriations.

7.56 Although the Department has identified major risks that affect the management of real property, its existing risk management systems are new and do not yet deal adequately with common, corporate-wide risks that could affect the Department's achieving its $1 billion cost-saving objective.

About the Audit

Objectives

The objectives of our audit were

- to assess the progress that Public Works and Government Services Canada (PWGSC) has made in responding to the observations and recommendations in our December 2002 Report, Chapter 8; and
- to assess whether the Department has adequately incorporated principles of risk management into its strategic planning for acquiring leased office space.

Scope and approach

The focus of our audit was to follow up on recommendations made in our 2002 chapter that were of greatest significance and risk—namely, that long-term options were fully considered and that progress was being made to improve information systems and the information provided to decision makers. We supplemented this work by examining leasing activities since our previous audit.

We also assessed the Department's risk management practices at the operational and strategic levels, with an emphasis on leasing of office accommodation.

Finally, to assess whether PWGSC considered all available long-term options for providing accommodation, we selected a sample of 27 of the 43 high-value leases the Department had entered into since our 2002 audit. We defined high-value leases as those with total payments of more than $1 million per year.

Criteria

The following criteria guided our audit work:

- The Real Property Branch should have appropriate tools to anticipate future needs, analyze a range of available options, and support its decisions. These tools should include strategic plans and models, policies and guidance, and management information and processes related to the acquisition of office space.
- In meeting the needs of client departments, the Branch should use the tools appropriately and consistently and follow relevant acts and regulations, Treasury Board policies and guidelines, and departmental policies.
- The Branch should have complete and accurate operational and financial information to support its managers' decisions.
- The Department should have identified and assessed risks flowing from its mandate to secure office space, and should have established appropriate risk mitigation procedures.

Audit work completed

Audit work for this chapter was substantially completed on 15 September 2005.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 7. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
Responsibility for costs of office space	
7.20 In its departmental performance report, Public Works and Government Services Canada should include progress against projected savings and the cost of those instances where the most cost-effective accommodation option was either not accepted or not enforced. (7.14–7.19)	**Public Works and Government Services Canada's response.** Shared responsibilities inevitably give rise to some inefficiency. There is now a renewed effort, supported by the Treasury Board Secretariat, to enforce standards for space and fit-up, and this is resulting in savings to the government. We will work with the Secretariat to include more reporting to Parliament on this issue.
Assessing options	
7.26 The Treasury Board Secretariat should develop a plan for departments to use financial information based on an accrual-based budgeting and appropriations approach in planning, budgeting, and reporting. (7.23–7.25)	**The Treasury Board Secretariat's response.** The Treasury Board Secretariat agrees that there are limitations associated with annual capital appropriations. The Secretariat is addressing the issues through two initiatives. The first initiative, as mentioned in the chapter, is the engagement of an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government. The Treasury Board Secretariat will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of the implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The government can approve changes to the budgeting process; however, Parliament must approve changes to appropriations.

Recommendation	Department's response
	The second initiative is a pilot project under development for non-lapsing capital appropriations. The pilot project proposes allowing up to three departments to carry forward unexpended asset funds from one fiscal year to the next, beginning as soon as next year. This will provide departmental managers with more flexibility in planning their operations and remove the current short-term focus of the planning horizon for asset and associated resources.
7.28 The Treasury Board Secretariat and Public Works and Government Services Canada should ensure that funding methods support the selection of the most cost-effective option that meets the long-term accommodation requirements. (7.27)	**Public Works and Government Services Canada's response.** We are pleased that the Auditor General has found that Public Works and Government Services Canada adequately analyzes the cost of accommodation options before decisions are made. The issue of how funding mechanisms affect rational decision making is an important one. We agree with the recommendation and will continue to work with the Treasury Board Secretariat and other parties to ensure that, wherever possible, funding mechanisms support the most cost-effective solution that meets the long-term accommodation requirements. We recognize that this may take some time to resolve since it represents a fundamental change to government accounting and budgeting. **The Treasury Board Secretariat's response.** The Treasury Board Secretariat recognizes that, in some instances, current funding mechanisms may limit PWGSC's ability to select the most cost-effective option for long-term accommodation requirements. The Capital Asset Review (CAR), conducted in 2004 as one of the federal government's expenditure management reviews, raised this same issue in the broader context of capital asset management. Responding to the CAR, the Secretariat is considering a more flexible funding mechanism, known as non-lapsing capital appropriations, and it has developed a pilot program with three departments to confirm the anticipated benefits of this option. Subject to this experience, the Secretariat will consider expanding the pilots to other departments and agencies, including PWGSC, providing they meet the participation criteria. The Secretariat will keep departments and agencies, including PWGSC, informed of progress in this area.

Recommendation	Department's response
	Irrespective of the potential change toward non-lapsing capital appropriations, PWGSC is responsible for managing its investment program, within existing reference levels. This must be done in accordance with key Treasury Board policies related to assets management, namely the Policy on Long-term Capital Plans, the Project Management Policy, and the Real Property Policy Suite, including the Treasury Board Real Property Investment Policy, all of which support least-cost best-value decisions.
Management information	
7.37 Public Works and Government Services Canada should continue to improve the availability, accessibility, and reliability of information to support sound decision making for real property investments. (7.34–7.36)	**Public Works and Government Services Canada's response.** We agree with this recommendation. While current systems enable Public Works and Government Services Canada to control costs incurred by the Department on individual projects, we recognize that our systems are cumbersome for overall management and acknowledge that improvements remain to be made.
Management property risks	
7.53 Public Works and Government Services Canada should • continue its efforts to develop guidance and to implement continuous risk management as part of the process for acquiring office accommodation, and • provide staff with the necessary training in risk management. (7.38–7.52)	**Public Works and Government Services Canada's response.** We agree with this recommendation. Public Works and Government Services Canada has made considerable progress in this area and will continue to do so. In areas of great importance, such as managing the risk related to achieving our five-year cumulative savings target of $150 million from leasing operations, we have implemented compensating controls. These controls include the establishment of a Strategic Transformation Branch to monitor and control achievement of our goals. In addition to implementing more rigour in its leasing practices and providing ongoing training to its staff, the Real Property Branch has implemented a Lease Savings Tracking System to monitor net transaction savings on a monthly basis. As a result of these measures, we have already achieved, as of 1 January 2006, more than half of our five-year cumulative savings target of $150 million, and will continue to monitor our progress carefully.

Chapter

8

Canada Revenue Agency
Collection of Tax Debts

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the [illegible] Board. Assurance [illegible] the Office's [illegible] standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Canada Revenue Agency
Collection of Tax Debts

Main Points

What we examined

We examined the Canada Revenue Agency's collection of tax debts, which we last audited in 1994 (when the Agency was Revenue Canada). In that audit, we reported that the Department's automatic risk-scoring systems, developed to help prioritize accounts for collection action, were ineffective. We also found that the Department lacked profiles of tax debtors, a fast-track approach to collecting all large tax debts, consistency in the way it assessed taxpayers' ability to pay, quality standards for the work of individual collectors, and adequate information on results to assess performance properly.

This time we examined whether the Agency uses efficient and timely processes to collect the unpaid personal tax, corporate tax, goods and services tax, and payroll deductions by employers that together constitute 86 percent of all tax debts.

Why it's important

In the vast majority of cases, taxes and payroll deductions owed are paid to the Agency on time. However, there is always a significant amount of taxes, penalties, and interest that the Agency has assessed but not collected. At 31 March 2005, the total amount in undisputed tax debt stood at $18 billion, of which the Agency expects to collect only about $13.3 billion—it considers the rest to be doubtful accounts and not collectible. The Agency also writes off a certain amount in uncollectible unpaid taxes every year—in 2004–05 the amount was $2.7 billion.

Managing and collecting tax debt is a complex activity involving more than 4,000 full-time-equivalent staff and many information technology systems. In 2004–05, the Agency collected tax debts of about $9 billion. Any improvement in its ability to collect tax debts efficiently and within a reasonable length of time could add millions of dollars in revenues to the Crown every year.

What we found

- Overall, the Agency has not made satisfactory progress in addressing the recommendations of our 1994 audit. Its approach to assessing files for risk continues to lack sophistication and has major weaknesses that impede the timely collection of tax debts. Further,

the Agency still lacks information needed to manage its collection of the tax debt effectively.

- The Agency has made some significant changes to its collection systems and some of its practices. It has updated its automated system that manages low-risk tax debts, opened a national call centre, and established national pools to better manage workload. It has improved the procedures to collect large tax debts.
- Cash collected by collectors working at Tax Services Offices has increased since 1994 and now stands at about $9 billion annually, or an average of about $2.3 million for each collector. Yet despite this increase, the tax debt has grown at a faster rate than total taxes paid. At the same time, management is not collecting the data it needs to understand both why the amount of tax debt is growing and what it comprises.
- Management also lacks important information on performance. The information used to manage the collection of the tax debt is focussed mainly on activities at Tax Services Offices, where the most complex accounts are handled. Little information is available on automated transactions and accounts processed at the national call centre. Information is not available on the effectiveness of the various types of collection actions, although it would be valuable in helping collectors select the best ones.
- The Agency has set ambitious goals in its strategic vision for the future of collections. However, there is still no detailed plan outlining the steps the Agency will take to address the specific challenges outlined in the vision or the measures that will be used to gauge progress toward its goals.

The Canada Revenue Agency has responded. The Agency has agreed with our recommendations and has indicated the actions it plans or has under way to address them.

Introduction

8.1 The vast majority of personal income tax, corporate tax, goods and services tax, and payroll deductions owed by individuals and businesses is paid on time. However, there is always a balance of unpaid taxes and payroll deductions—at 31 March 2005, about $18 billion in undisputed assessed taxes, interest, and penalties remained uncollected. Each year the Canada Revenue Agency writes off a certain amount of tax debt that it considers uncollectible; in 2004–05 it wrote off $2.7 billion in taxes, penalties, and interest.

8.2 Collecting outstanding tax debts is one of the responsibilities of the Agency's Taxpayer Services and Debt Management Branch (see "How the collection system works," page 240). In 2004–05 the Agency had over 4,000 full-time-equivalent staff—mainly collection officers, team leaders, and managers—collecting tax debts in Tax Services Offices across Canada and at the national call centre in Ottawa. The 2005–06 budget for collecting tax debts was $215.9 million.

8.3 The Agency is obligated to collect all taxes and related interest and penalties owed to the Crown; unlike a private sector creditor, it cannot choose its clients. Nor can it refuse services or credit to taxpayers with a poor payment history. A private sector creditor can mitigate its credit risk by charging higher interest rates for riskier clients or demanding security when extending credit, options unavailable to the Agency. However, the Agency can take certain legal actions more easily than private sector creditors; for example, it can issue a garnishee without going to court.

8.4 As well as collecting federal income taxes, the Agency has agreements with all provinces but Quebec to collect provincial income taxes on their behalf. The federal government pays each province the total amount assessed for its provincial income taxes, whether or not the Agency ultimately collects that amount. The federal government keeps any interest earned and certain penalties owed.

8.5 As of 1 August 2005, the Agency also collects debts for Human Resources and Social Development Canada (formerly Human Resources and Skills Development Canada and Social Development Canada) on accounts such as Canada Student Loan, Employment Insurance, and Canada Pension Plan.

Key findings in 1994

8.6 We last audited the collection of income tax debts in 1994, when it was managed by Revenue Canada. In that audit we reported that the Department's automatic risk-scoring systems, developed to help prioritize accounts for collection action, were ineffective. We said it needed to develop profiles of tax debtors, institute fast-track collection of all large tax debts, ensure that collectors used consistent practices in assessing taxpayers' ability to pay, strengthen quality standards for the work of individual collectors, and develop better information on results for use in assessing the performance of collection activities.

How the collection system works

When tax assessments or reassessments are not paid, the unpaid balances are drawn from the appropriate accounting system and become collection accounts. There is a separate accounting system for each revenue line—personal income tax, corporate tax, goods and services tax (GST), and payroll deductions by employers.

The Agency tries to collect the full balance of a tax debt or make an arrangement for payment in full within a certain amount of time. When it is not possible to arrange a payment, legal action can be taken. Legal actions include, but are not limited to

- garnisheeing wages or pensions or accounts receivable,
- setting off the debt against other government payments,
- seizing assets,
- certifying the debt in Federal Court, and
- putting a lien on a taxpayer's assets.

The Agency can take tax debtors to court to collect the unpaid debt.

A combination of procedures, both automated and by human intervention, is used to collect outstanding tax debts. The procedures used include computer-generated letters, telephone calls, field visits, and legal actions. Collection actions take place automatically through REMITS (Revenue Enforcement Management Information Tracking System), at a national collections call centre in Ottawa, at eight locations that collect for two national pools of accounts (personal tax and GST), and at Tax Services Offices across Canada. The size and complexity of an account determine which collection mode will be used.

REMITS sends out letters to tax debtors and handles some accounts for which arrangements have been made. The call centre conducts mainly outbound calls to tax debtors whose debts are below a certain dollar limit. The call centre has a telephone system that allows it to automatically dial out to taxpayers. The national pools conduct mainly outbound calls to tax debtors, regardless of geographic boundaries, for individual tax and GST owed below a certain dollar limit. The pools also conduct limited enforcement actions such as garnishees. The Tax Services Offices work on the larger and more complex accounts and conduct a full range of legal actions, such as seizing assets and placing liens on the property of tax debtors.

Information technology systems. The Agency has several systems that help it undertake and manage collection activities. Because the Agency collects debt on all revenue lines, its information technology systems have to connect to the information technology systems of all revenue lines. The unpaid balances of tax, penalty, and interest for personal and corporate tax are transferred from the accounting systems into two collections systems: the management information system STARS (Statistical Tracking Analysis and Reporting System) and REMITS. The unpaid balances of goods and services tax and payroll deductions are transferred to ACSES (Automated Collections and Source Deductions Enforcement System).

The STARS system provides information to staff to manage their operations. It provides information on new debt assessed but not paid, cash collections, write-offs, debt aging, and revenue line. A query facility allows for queries of accounts.

REMITS applies a risk model to individual and corporate tax debts to determine whether they should be handled by REMITS, the call centre, a national pool, or Tax Services Offices. REMITS then handles some accounts automatically and routes others to the appropriate location.

Collection officers use a system called ACSES to manage their accounts. ACSES allows collection officers to document the details of day-to-day collections activity on each account in a diary, bring forward work, refer work to team leaders and managers for review and approval, and link to other Agency systems.

Important changes since 1994

8.7 In 1995, the House of Commons Standing Committee on Public Accounts expressed concern about the Department's estimate of the realizable value of tax debts, its lack of effective risk scoring and fast tracking of large debts for collection, the lack of information and consistent guidelines on applying the **fairness provisions**, and a lack of information for parliamentarians. The Department's plan of action to address the Committee's concerns included completing an integrated revenue-collections system, making early contact on large accounts, setting up call centres, and enhancing the assessment and scoring of accounts for risk.

Fairness provisions—Legislation that allows the Minister of National Revenue to waive or cancel all or part of any interest or penalty owed by a taxpayer because of a delay or error by the Agency, circumstances beyond the taxpayer's control, or the taxpayer's inability to pay. (Amounts waived have not yet been charged; amounts cancelled have already been assessed.)

8.8 Also in 1995, Revenue Canada completed a study of the collections process. The study questioned the effectiveness of sending multiple letters to advise debtors of the amounts they owed. It found that Revenue Canada's existing system did not identify potentially high-risk debtors and that long delays occurred before collection officers took action. It also found that industry good practice was to contact tax debtors early in the collections process and recommended that a national call centre be set up.

8.9 To address these weaknesses, Revenue Canada developed and installed the Revenue Enforcement Management Information Tracking System (REMITS) in 1997. This automated system was designed to route accounts to the appropriate mode of collection, based on risk. It was also designed to manage the movement of accounts through the collections system. A national call centre was set up the same year to handle high-volume, uncomplicated collection accounts.

8.10 The Canada Revenue Agency was established in 1999. Its Board of Management oversees the organization and administration of the Agency and the management of its resources, services, property, personnel, and contracts. The Minister of National Revenue remains accountable for the Agency.

8.11 In 2002, the Agency found that it was still having difficulty dealing with the volume of collection accounts and the increasing number of aging accounts. It decided to establish national pools to handle certain more complex accounts from anywhere in the country and accounts that the call centre was not able to collect. The pool concept, and the call centre concept before it, changed the traditional assignment of work based on geographical boundaries. National pools of personal tax debt accounts were established in April 2003 and of goods and services tax debt accounts in April 2004. Depending on

their size and complexity, collection accounts can now be handled by REMITS, the call centre, a national pool, or a Tax Services Office.

8.12 The Agency has created the Continuous Improvement and Quality Assurance Section (CIQAS) to monitor collections at the Tax Services Offices. The Section reviews the application of collection policies and procedures, identifies and shares best practices, and reviews active and written-off accounts.

8.13 In 2004, the Agency split the Assessment and Collections Branch into the Assessment and Client Services Branch and the Revenue Collections Branch. Each Branch is headed by an Assistant Commissioner. In January 2006, the Revenue Collections Branch was given additional responsibilities and became the Taxpayer Services and Debt Management Branch.

Focus of the audit

8.14 The objective of our audit was to examine whether the Canada Revenue Agency uses efficient and timely processes to collect tax debts. Our audit focussed on the personal tax, corporate tax, goods and services tax, and payroll source deductions that constitute about 86 percent of all tax debts. We also considered whether the Agency has made satisfactory progress on the issues that we reported in 1994 and that Revenue Canada also reflected in its 1995 action plan to the Public Accounts Committee (see "Progress in addressing our 1994 recommendations on collecting income tax debts," page 260).

8.15 We did not examine debts for which the taxpayers were disputing the assessment that gave rise to the debt, given that in most such cases the law prevents the Agency from taking any legal collection action. Nor did we examine miscellaneous tax debts, which include non-residents' taxes, other levies, excise fees, and customs fees.

8.16 We did not include write-offs or fairness provisions in our audit, as in 2002 we reported that the Agency had reasonable controls in place to guard against inappropriate write-offs of taxes owed and had improved its administration of the fairness provisions (April 2002 Report, Chapter 2, Canada Customs and Revenue Agency—Tax Administration: Write-Offs and Forgiveness).

8.17 Further details on the audit can be found in **About the Audit** at the end of the chapter.

Observations and Recommendations

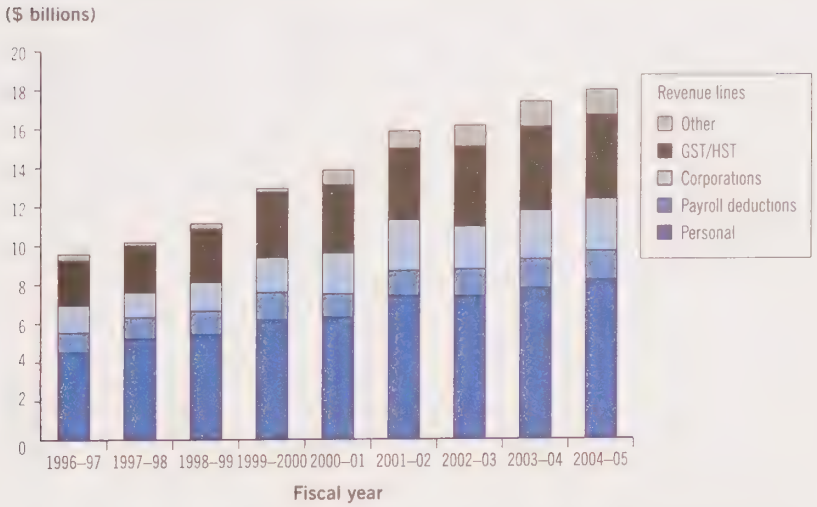
The tax debt continues to grow

Undisputed tax debt is more than $18 billion

8.18 At 31 March 2005, uncollected taxes, interest, and penalties owed and undisputed totalled about $18 billion and involved about 3.3 million accounts. Debts for which taxpayers were disputing the assessment that gave rise to the debt accounted for about $6 billion more. Debts related to personal income tax are about 45 percent of the total, a proportion that has not changed since 1996–97 (Exhibit 8.1).

8.19 **Cash collections have risen and targets have been exceeded.** Cash collections at Tax Services Offices (including national pools) rose from $5.3 billion in 1996–97 to $8.8 billion in 2004–05 an average increase of $0.5 million for each collector. In 2000 the Agency estimated that the total tax debt could reach about $28 billion by 2004–05, and it requested added resources to help it slow the growth. It received the requested resources for the fiscal years 2001–02 to 2004–05 and made a commitment to keep the tax debt below a certain level for each of those years. It also made a commitment to collect a specified amount of cash in each fiscal year of that period. It has exceeded its targets in both cases (Exhibit 8.2).

Exhibit 8.1 The composition of the tax debt by revenue line



Personal income tax debt makes up the largest portion of the tax debt. The proportion of personal to total income tax debt has not changed since 1996–97.

Source: Canada Revenue Agency

8.20 Despite these efforts, however, the tax debt has grown 88 percent since 1997, while the Agency's total cash receipts (taxes paid) have grown 48 percent (Exhibit 8.3). In other words, the tax debt is growing at a faster rate than total cash receipts. The Agency needs to understand why this is happening so that it can develop strategies to slow the growth of the tax debt.

8.21 The ratio of tax debt to total cash receipts is a trend indicator of how well the Agency is managing the tax debt, and this ratio has grown from 4.27 percent to 5.43 percent since 1997. From 2003–04 to 2004–05, there was a small reduction in the ratio due mainly to increased write-offs of uncollectible accounts. (The write-offs amounted to $2.7 billion; annual write-offs have historically averaged about $1.3 billion.)

Exhibit 8.2 The Agency has kept tax debt below estimated levels while cash collections at Tax Services Offices have exceeded targets



The goal was to keep tax debt at or below the estimate



The goal was to meet or exceed the target for cash collections

*Includes national pools

Source: Canada Revenue Agency annual reports

Exhibit 8.3 The tax debt is growing at a faster rate than total cash receipts (taxes paid)

	1996–97	1997–98	1998–99	1999–2000	2000–01	2001–02	2002–03	2003–04	2004–05	Growth since 1996–97
Total tax debt ($ millions)	$9,583	$10,199	$11,161	$12,974	$13,907	$15,913	$16,208	$17,439	$18,027	88%
Total cash receipts ($ millions)	$224,554	$244,777	$255,864	$274,535	$294,788	$300,058	$305,656	$314,519	$332,088	48%
Total tax debt as a percentage of cash receipts	4.27%	4.17%	4.36%	4.73%	4.72%	5.30%	5.30%	5.54%	5.43%	

Source: Canada Revenue Agency annual reports and cash receipts reports

Management lacks information on why the tax debt is growing

8.22 Poor understanding of the makeup of tax debt. We found that the Agency does not have a full understanding of the composition of the tax debt and why it is growing. In 2003 and again in 2004, the Board of Management expressed concern about the increase in tax debt. It indicated a need for a clear and concise explanation of the reasons for growth and for an action plan to address them. A recent Internal Audit review set out to identify trends and factors that have contributed to the growth of tax debt and to provide the explanation requested by the Board. However, that review was hampered by a lack of consistent data to analyze. The review suggested some possible causes for the growth but was unable to provide a clear and concise explanation. The Agency presented an action plan that included establishing a framework for analyzing trends in tax debt growth by revenue line.

8.23 We also found a lack of consistent data to help the Agency understand the makeup of the tax debt, explain why the tax debt is growing, and develop a strategy for collecting it. For example, the Agency does not track how much of the tax debt represents initial assessments, reassessments requested by the taxpayer, or reassessments initiated by the Agency. Debts are sometimes harder to collect when the Agency initiated the reassessment than when the taxpayer requested it, and those cases call for a different collection strategy.

8.24 **Allowance for doubtful accounts is more than one quarter of total tax debt.** The recent Internal Audit review noted that the allowance for doubtful accounts was at an "unhealthy" level. Although the $2.7 billion write-off of accounts in 2004–05 significantly reduced the allowance as a percentage of tax debt, it is still equivalent to over 26 percent of the total tax debt (Exhibit 8.4). This indicates that the Agency continues to carry many accounts with little potential for recovery.

8.25 For the last three years the Agency has conducted an exercise to determine, for financial statement purposes, what allowance to make for doubtful accounts. The allowance for doubtful accounts reflects management's best estimate of the collectibility of amounts assessed but not yet paid. The Agency reviewed about 3,000 accounts for the year ended 31 March 2005 to evaluate how collectible each tax debt was. It did not use the information gathered in this exercise to help it understand why some accounts become uncollectible in order to develop better strategies for dealing with aged accounts. However, in the fall of 2005, the Agency initiated a separate review of uncollectible tax debts to understand why accounts become uncollectible. It will review a sample of uncollectible accounts and analyze the results to identify factors that may reduce or eliminate the Agency's potential to recover the debts.

8.26 **Instalment remitters are an ongoing concern.** Employed taxpayers generally have income taxes deducted from their pay and remitted to the Agency by their employers. Others are required to pay instalments themselves throughout the year to cover their taxes. The Agency charges interest on instalments that are insufficient or not paid on time but has few other means to enforce the requirement. About 40 percent of accounts in the sample we selected from personal income tax debts involved instalment remitters, suggesting a compliance problem in this category. The Agency estimates that the number of instalment remitters with tax debts who have not paid their assessed

Exhibit 8.4 Allowance for doubtful accounts shows many tax debts are likely uncollectible

Year	2002–03	2003–04	2004–05
Tax debts ($ billions)	$16.2	$17.4	$18.0
Allowance for doubtful accounts ($ billions)	$5.4	$5.7	$4.7
Allowance for doubtful accounts as a percentage of tax debts	33.3%	32.8%	26.1%

Sources: Canada Revenue Agency annual reports and allowance for doubtful accounts documents

taxes is about 85,000; they account for about 38 percent of total taxes owed by individuals. However, the Agency does not have more detailed information about these remitters that would allow it to understand the extent of the non-compliance and the reasons for it, so that it could develop strategies to promote compliance.

8.27 The Agency has tried to address the problem of the many instalment remitters who have not paid their assessed taxes. It has provided information on its Web site and, in 2003–04 and 2004–05, collection officers at the call centre telephoned taxpayers who had not paid their quarterly tax instalments and reminded them to send in the payment.

8.28 Recommendation. The Canada Revenue Agency should identify and collect the data it needs to analyze the makeup of its tax debt and to develop better collection strategies.

The Agency's response. The Agency agrees that understanding the makeup of tax debt is an important factor in developing its strategies, although the Agency's efforts have resulted in increased collector productivity since 1994. In addition, the Agency has exceeded important program delivery commitments made to the Treasury Board, as noted in this chapter.

The Agency has taken important steps to increase its capacity in the area of tax debt research by launching the Agency's Integrated Revenue Collections (IRC) project, which is developing advanced data-warehousing and data-mining capabilities. In addition, the Agency has set up a team within its organization dedicated to conducting debt management research. These initiatives will support the horizontal approach to compliance research across the Agency. The Agency is taking important steps to ensure that the IRC project is being managed in accordance with accepted project management practices. Some deliverables have already been released, such as the All Revenue Tables.

Management lacks important information on performance

8.29 Management needs to have the right performance information to ensure that its strategies are working and its resources are assigned to the right areas. Our review of good practices found that organizations are building flexible management information systems to allow for customized management reports that can answer a wide range of questions. Combined with a data analysis tool, this gives them more ability to analyze their operations and improve their performance.

Lack of information on different modes of collection

8.30 The Agency's Statistical Tracking Analysis and Reporting System (STARS) provides monthly summary-level information on new accounts received, cash collected, amounts written off, and the aging of accounts. We found that management information covers mainly the collection actions at Tax Services Offices. For example, STARS keeps track of cash collected at the Tax Services Offices (including the national pools). It does not track cash collected by the automated system and at the call centre. Information on automated transactions and on call centre and national pool activities is difficult to obtain and is lacking in reports to management and to Parliament. When Revenue Canada installed the call centre and the REMITS system, it noted the need to maintain certain key performance measures such as dollars collected by the various collection modes, but this has not been done. Furthermore, we found that reports to management contain no information on the significant portion of tax debt that is managed by automated systems—about 2.4 million accounts totalling about $2.6 billion.

8.31 It is important that the Agency track amounts collected by each collection mode. Because the Agency is not tracking these amounts, it is difficult to determine whether the call centre has been a worthwhile investment, or whether the national pools are more efficient than the Tax Services Offices were at collecting similar accounts. Furthermore, without this information it is difficult to optimize the allocation of resources among the four collection modes, taking into account the need for fair and consistent treatment of all taxpayers and the need to encourage compliance.

Lack of information on results of collection actions

8.32 We found that good collection practices are aimed at getting the best return on investment. Collectors can use a range of approaches that produce different results. Like the Agency, other collectors typically lack enough resources to act on every account but, through careful analysis of return on investment, they can use the collection tools that bring the highest returns.

8.33 In our sample of Agency accounts, we noted that collection officers record many collection actions in their diaries. But there is no automated summary of these actions or their results to help collection officers and their supervisors understand which actions are the most effective. For example, there is no summary of

- requirements for information (notices issued to financial institutions and others);

- garnishees (requirements to pay);
- certificates filed in federal court to secure the debt;
- liens entered in the land registry or personal property registry; and
- credit bureau searches.

8.34 Nor is management given a useful periodic summary of collection actions taken and their results. Such a summary would help it identify which actions are getting the best results. That information could then be used to analyze the Branch's collection strategy and to help determine how to use collection tools more effectively.

Lack of comprehensive information

8.35 **No information on frequency of danger-of-loss reviews and jeopardy applications.** Legislation prevents the Agency from starting legal collection action on most categories of debt until 90 days after it issues a notice of assessment. This is to allow the debtor time to file a notice of objection. However, a provision of the legislation allows the Agency to enforce payment immediately by making a jeopardy application—that is, satisfying a judge that it has reasonable grounds to believe a delay would jeopardize the ultimate collection of the debt. We noted in 1994 that Revenue Canada was not keeping track of how many cases involving danger of loss had been referred to legal counsel by collectors, how many had proceeded to court, and how many had been decided in the Crown's favour. Our follow-up audit found that the Agency is still not tracking this information and therefore does not know how effectively the legislative provision works.

8.36 **Lack of information on insolvency files.** Usually in a case of insolvency, the amount of tax debt the Agency can collect is quite small. Yet insolvency accounts can consume a significant amount of a collector's time. The Agency does not have complete data on the number of accounts, and the size of debt affected by insolvencies. Nor does it have information on the amount of time collectors are spending on these accounts, although it plans to start collecting it. Such information is essential to developing a good collection strategy for managing insolvency files.

8.37 **A new system to capture results shows promise.** In 1994 we found that information on results was insufficient to properly assess collection performance, by team or by individual. In the early stages of the present audit, team leaders and managers told us that the management information system still did not show results by team or by individual collector; team leaders and managers were collecting the

information themselves. In the summer of 2005, a new system, All Revenue Tables (ART), began operating in three regions. Team leaders and managers told us they find ART a useful tool for capturing information on individual and team performance.

A key performance indicator has weaknesses

8.38 One of the key performance indicators the Agency uses is the ratio of the value of accounts resolved to the value of new accounts and interest owed on old accounts. In our view, this indicator does not provide a clear measure of performance because it compares unlike elements—such as cash collected on old accounts compared with the intake of new accounts (Exhibit 8.5). Furthermore, the indicator is not complete because it considers only accounts handled at the Tax Services Offices and national pools, ignoring the accounts that are managed by the automated system or handled at the call centre.

Exhibit 8.5 **Key performance indicator**

$$\text{Performance indicator} = \frac{\text{accounts resolved at Tax Services Offices (cash collections on new and old accounts + accounts written off)}}{\text{intake of accounts at Tax Services Offices (new accounts assigned + interest on old accounts not resolved)}}$$

The indicator does not provide a clear measure of performance because it compares unlike elements and is incomplete.

Source: Canada Revenue Agency

8.39 Using this indicator, the Agency reported to Parliament that accounts resolved matched the intake of new debt in 2004–05, a result the Agency had not achieved in some time. The Agency was able to report this result in part because the indicator includes write-offs of uncollectible tax debts. In 2004–05, write-offs amounted to $2.7 billion, about double the historical average.

8.40 The Agency's Report on Plans and Priorities has proposed a new indicator of performance for 2005–06: the percentage of intake resolved in the year of intake. The annual target for performance is 60 to 65 percent. This represents an improvement, if it includes cash collected on all accounts by all modes of collection (automated system, call centre, national pools, and Tax Services Offices) and does not include write-offs in the calculation.

8.41 **Recommendation.** The Canada Revenue Agency should significantly improve its management information to make it complete and comprehensive. It should develop reliable techniques and information sources to determine on a regular basis the results of its collection efforts and use that information to guide its decision making for each of its major collection modes and actions.

The Agency's response. The Agency agrees that improvements are needed to enhance its management information systems—improvements that are currently being addressed through its Integrated Revenue Collections project. However, the Agency believes that the performance indicators it has established for its collections program appropriately reflect program activities, including write-offs.

The Agency continues to review its performance indicators in order to ensure their accuracy and appropriateness. This review is in line with the OAG's annual performance assessment on the fairness and reliability of the program information described in the Agency's Annual Report to Parliament.

The Agency continues to manage uncollectible accounts in accordance with the procedures that were favourably reviewed by the Auditor General in 2002.

Risk management is deficient

Managing risk is critical to collection efforts

8.42 Risk management is widely acknowledged as a critical factor in the proper management of any collection function. It is even more critical when that function lacks enough resources to handle a growing and aging backlog of tax debt. Our review of good practices found that public and private sector organizations are not only using risk management widely but are using sophisticated risk management models in collection activities.

8.43 These organizations are scoring accounts based on risk to help their collectors identify the accounts that involve the highest risk and the highest potential payback. With this information, they can direct their efforts more effectively. Generally, an account is assessed for characteristics that signal a risk of uncollectibility, and the combined characteristics (risk factors) yield an overall risk score. Risk scoring is then used to determine collection procedures. For example, high-risk accounts could be subject to aggressive action, whereas a more moderate approach would be used for accounts that are likely to be paid.

Some improvements have been made to risk assessment systems

8.44 The Agency does not have a collections risk management framework as such, but it does use certain elements of risk assessment. For example, the installation of REMITS in 1997 updated the risk-scoring system for individual and corporate accounts. The Agency has not yet extended the system to goods and services tax or payroll deduction accounts, although that was originally intended.

8.45 REMITS applies a risk model to individual and corporate tax debts and, based on either the dollar value of an account or the risk score, it assigns one of several collection strategies. The size of the tax debt is the main factor that determines the collection strategy. Generally, accounts with small balances are managed by REMITS, with letters sent automatically to the tax debtor. Others are handled by the national call centre or the national pools. Accounts with a high balance and a high risk score are generally routed to Tax Services Offices.

8.46 The Agency intended to review the risk-scoring system on a regular basis but has never done so. Furthermore, the Agency has not done a complete test of REMITS since its inception to ensure that it is working as intended. Documentation of the system's risk-scoring module has been poor, so we were unable to determine how the risk scores are calculated and whether they are appropriate. Nor were we able to determine whether REMITS was assigning accounts to the appropriate collection strategies.

Deficiencies identified in 1994 remain

8.47 Our 1994 audit recommended that action be taken to address the several risk management deficiencies we identified:

- The automatic risk scoring of delinquent accounts was ineffective because the risk assessment was limited mainly to the outstanding balance and the age of the account; other important risk factors either were not considered or did not weigh heavily in the risk scoring.
- The risk scores were rarely updated or used to prioritize workload.
- There were no profiles of tax debtors for use in modifying basic collection strategies to improve recoveries from debtors who posed a high risk of non-payment.

- When individuals or corporations had tax debts in more than one revenue line, their total tax debt was not provided automatically. Collectors had to search manually for tax debts across several systems, leaving open the possibility of untimely, inconsistent, or no collection action and thereby raising the risk of loss.

In our follow-up audit, we found that the Agency has not yet dealt with these deficiencies adequately.

8.48 Key factors are not integrated into the initial risk assessment. REMITS performs the initial risk assessment of personal and corporate tax debts. The risk assessment does not appear to formally consider key factors such as whether the debtor can likely pay, whether the debtor owes in another revenue line, whether the debt arose from a self-assessment or an Agency action, or whether the debtor has previously filed for bankruptcy. The debt and debtor history are not factored into the risk score. Because the initial risk assessment does not formally consider any of these key factors, the Agency has no assurance that the riskiest files are given priority.

8.49 Insolvency risk factors are not incorporated into risk assessment. The Agency has completed four studies that have identified criteria historically associated with insolvency. To date, these criteria have not been used in assessing a file for risk when it first enters the collections inventory, or even when it is assigned to a Tax Services Office for collection. Using indicators of potential insolvency in the screening of files could lead to changing the collection approach in high-risk cases—for example, moving faster to certify the debt, or issuing an enhanced "requirement to pay" if the taxpayer has been bankrupt before.

8.50 Automated system is not used by collectors to prioritize workload. When accounts are routed to Tax Services Offices, they are given a risk score by the Automated Collections and Source Deductions Enforcement System (ACSES). ACSES risk scores are used in the national pools and some of the Tax Services Offices to assign cases to collection officers. However, we found that collection officers do not understand or use the ACSES scores. They do their own risk assessments to set their workload priorities. Collectors' risk assessments are not part of the automated system.

8.51 Risk assessments are not updated to reflect changes in risk levels. The initial risk assessment is just one element of proper risk management. It is important to also continue modifying and updating the assessment with additional information as new developments occur in the handling of the account. We found no evidence that updating the automated risk assessment for factors other than the size or age of the debt is an ongoing activity. For example, the Agency now allows collection officers to obtain the tax debtor's credit history from a credit bureau, but this information is not used to update the risk scores.

8.52 Recommendation. The Canada Revenue Agency should establish a more comprehensive automated risk-scoring system for tax debts, update the risk scores on an ongoing basis, and use the risk scores to prioritize workload throughout the collections process.

The Agency's response. The Agency agrees. Additional investments in risk management systems are needed, and are being made, to realize the full potential of the Agency's collections program and to address the continued growth in accounts receivable. The Agency's Integrated Revenue Collections project is focussed on addressing both past and current concerns raised by the Auditor General with respect to risk assessment and file management, in addition to the above-mentioned management information system improvements.

Efficiency improvements needed

Early action is important in collecting tax debts

8.53 Our review of good practices found that taking action early in the lifecycle of a tax debt account is important to successful collection. Debts become significantly less collectible over time. Moreover, the sooner action is taken, the more likely it is to result in collecting the full debt.

8.54 Some improvement since 1994 on procedures to collect large debts. In 1994 we noted that most large tax debts were not fast-tracked for collection. In this follow-up audit, we found that about 76 percent of accounts over $100,000 in our audit sample were looked at within 10 days of their transfer to the Branch. Assistant directors of collections at the Tax Services Offices we visited conduct quarterly reviews of high-value accounts. The reports we looked at by the Continuous Improvement and Quality Assurance Section indicate that the appropriate reviews of large-dollar active accounts are done about 70 percent of the time. The new ART system also provides information on high-value accounts, which helps managers in Tax Services Offices manage their large tax debts.

8.55 Reporting on timeliness. The Agency has recognized the importance of timeliness by including it as an expected result in its Report on Plans and Priorities and in the Branch's Strategic Plan for 2005 to 2010. However, its Annual Report is silent on how quickly accounts are moving through the collection systems. The Agency does not maintain data on the time that elapses between collection actions on an account. Nor does it maintain data on the time that elapses between the date when a debt becomes payable and the date when it is fully paid. Therefore, it is difficult to determine whether the Agency's handling of collections is timely.

Aging accounts are a problem

8.56 The Agency's 2004–05 Annual Report stated that 47.8 percent of the value of the tax debts handled at the national pools and the Tax Services Offices was more than two years old, slightly down from 48.8 percent in March 2004 (Exhibit 8.6). Our analysis of the value of the tax debts in the Agency's inventory at the end of March 2005, including accounts handled by the automated system, showed similar results.

Exhibit 8.6 Almost half of the tax debt at Tax Services Offices* is over two years old



*Includes national pools

Source: Canada Revenue Agency 2004–05 Annual Report

8.57 Some files are handled by several collectors. In our audit sample of active accounts, we found that an average of 5.3 collectors had worked on each account (with the exception of automated accounts) and that each account had an average age of 3.2 years. This meant that each account averaged a new collection officer every seven

months. Staff at Tax Services Offices told us that accounts are reallocated among collectors fairly often, for a number of reasons—collectors leave, teams reorganize, and managers feel that accounts frequently need to be seen through "fresh eyes." These reallocations can result in several months of inattention to an account—delays that can be costly to debt recoveries.

8.58 **Some files need stronger collection action.** We also noted in the sample that collectors focussed on collection actions such as letters, telephone calls, and garnishees. Often, they did not take stronger enforcement actions to secure the debt until much later in the collection process, if at all.

Case management system needs improvement

8.59 The number of accounts that collection officers maintain in their inventories varies between 15 and 300. The more senior officers maintain a low number of complex cases and also act as a resource and trainer for less experienced staff. The more junior officers maintain a higher number of less complex cases in their inventories and spend most of their time working on their accounts.

8.60 Collection officers depend heavily on information technology systems and use ACSES in the day-to-day management of their accounts. The most important tool in ACSES is the diary where they record the collection actions they have taken. These actions include making telephone calls, sending legal warning letters, sending requirements for information to financial institutions and other third parties, garnisheeing bank accounts or wages, registering the debt, seizing assets, and placing liens on property. The length of the diaries can run from a few pages in a straightforward case to many pages in a more complex case. Reviews by team leaders and managers are also recorded in the diaries.

8.61 Collection officers told us that ACSES is not user-friendly or efficient. They described the following as major problems:

- The system still does not present the collection officer with all tax debts in the various revenue lines that are associated with one tax debtor. Officers have to locate the tax debts and associate them with the debtor.
- No common diary is established for debtors who have unpaid balances in more than one revenue line; collectors have to move back and forth between diaries.

- Officers have to use function keys rather than a mouse, making the system tedious to use.
- It is difficult to summarize the information contained in a very detailed diary.
- Accessing other Agency systems is time-consuming.

8.62 **Tax Services Offices have developed their own tools.** To try to overcome these problems, Tax Services Offices have developed new tools that collection officers are using. The tools are designed to reduce the time spent on repetitive tasks, develop electronic forms, and convert ACSES to a point-and-click system. Collection officers told us that the tools have indeed cut down the time they spend on repetitive tasks and have improved their efficiency. We note that the use of these tools is uneven across Tax Services Offices.

8.63 The new tools present a higher risk that data integrity will be compromised, because they are easily written, easily altered (deliberately or inadvertently), and not subject to the organizational development, maintenance, and control procedures that other applications usually undergo. Furthermore, they access many different applications that contain sensitive information on taxpayers. Headquarters is trying to understand the use of the new tools by building an inventory and developing controls. It recently approved some tools for use in collection activities. While we appreciate the efficiency improvements that the new tools bring, we are concerned about the risks involved and the length of time it has taken to develop controls.

Some steps have been taken to improve efficiency

8.64 In addition to setting up the national call centre and the national pools, the Agency has taken other steps to improve efficiency and incorporate good practices. These include the following:

- The Branch integrated the goods and services tax debt workload into its operational systems.
- The Branch has an electronic collection manual easily accessible by all collection officers. We heard positive comments from staff about the manual.
- The collection manual includes guidance on monitoring debtors' ability to pay. The guidance outlines when and how to determine both an individual's and a corporation's ability to pay.
- The Branch participates in the International Debt Management Committee of six countries' representatives who are responsible for debt management. The committee members compare approaches to debt management and share good practices.

- The Agency provides a wide variety of payment options for tax debtors. These include payment by cheque, post-dated cheque, or pre-authorized debit, and payment at financial institutions, on-line, or by telephone.

8.65 **Recommendation.** The Canada Revenue Agency should minimize the number of collectors who work on each account, record their collection actions in a more systematic way, and improve the case management tools they have at their disposal.

The Agency's response. The Agency agrees. The Agency will undertake an initiative to identify file management inefficiencies and improve the effectiveness of collector actions on case inventories.

The Agency will build on process improvements it has made, such as the national collections call centre and national pools, to further improve its file management. More specifically, the Integrated Revenue Collections project will improve the case management tools available to perform all Agency collection activities.

Future vision is ambitious

8.66 The Agency recently developed a strategic vision for the Revenue Collections Branch. The vision sets out ambitious goals to be achieved by 2010. It incorporates many good practices used or planned in other jurisdictions and in the private sector. For example, the vision calls for better management of tax debt risks, using a new technological platform.

8.67 The strategic vision includes five strategic directions:

- an integrated client-centred approach that will allow for a progressive integration of the Branch's workload so that all issues surrounding a particular debtor will be identified and dealt with by one Agency officer;
- a new technological platform that will allow the Agency to start using information strategically and improve the way it identifies, manages, and distributes workload;
- the pursuit of legislative amendments to address compliance and collection issues and to improve the framework under which the Agency and taxpayers operate;
- improved support for employees to help them adapt to a new work environment; and
- the creation of new strategic partnerships and the strengthening of existing ones, with a view to assuming additional collection responsibilities.

Vision extends 1994 concepts that have not been fully developed

8.68 In 1994 we noted that the Department intended to have the same collector follow up on unpaid assessments of the various kinds of taxes owed by a given taxpayer—a client-centred approach for collections. Since then the Agency has made some progress toward this approach, although difficulties with its computer systems have prevented it from fully achieving the goal. The Agency now plans to extend the concept of a client-centred approach to integrate both the collections and compliance workloads handled by the Branch—a significant challenge, since the collections workload itself is not yet fully integrated.

8.69 In 1994 we noted that the scoring of delinquent accounts by risk was ineffective and that profiles of tax debtors did not exist. The Department agreed that it needed to establish an appropriate system for risk scoring and to develop debtor profiles. Since then the Agency has updated the rudimentary risk scoring in its computer systems, but it still has no profiles of tax debtors. The Agency expects the new technological platform called for in the strategic vision to help it prioritize and allocate work based on assessed levels of risk. Since little of the information needed to do comprehensive risk assessments currently exists in a usable form, it will have to be assembled and incorporated into existing or new technology platforms before results can be achieved.

Implementing the vision will require detailed planning and diligent attention

8.70 The vision identifies the major challenges in collecting tax debts—namely, the consistent growth in the number of tax debts, the gap between "intake" (new assessments not paid and interest on old debt) and "production" (cash collected and amounts written off), and the aging of the debt portfolio. However, at the time of the audit, the Agency had not prepared detailed plans that set out how it will meet the challenges outlined in the strategic vision. Moreover, the Agency lacks the information it needs to create such a plan and measure progress toward it.

8.71 The Agency's slow progress on risk assessment and workload management since 1994 can be explained in part by technology problems and the slow development of technology solutions. But much of the strategic vision hinges on significant investments in a new technology platform, and these investments need to be carefully managed.

Progress in addressing our 1994 recommendations on collecting income tax debts

Recommendation	Progress
1994 Report of the Auditor General, Chapter 29	
The Department should establish an appropriate system for risk scoring of delinquent debts, develop debtor profiles and customize collection procedures as required (paragraph 29.64).	○
The Department should introduce procedures for collecting on all large debts soon after they become due (paragraph 29.75).	●
The Department should monitor the number of danger-of-loss cases referred to legal counsel by collectors, the number presented to courts and the extent to which favourable judgments are granted, and should assess the extent to which legislative provisions are sufficient to shelter the Crown from potential loss (paragraph 29.75).	○
The Department should establish clear standards for assessing, documenting and verifying information pertaining to debtors' ability to pay, together with expected time frames for making and updating such assessments. The Department should monitor collectors' adherence to such standards (paragraph 29.80).	●
The Department should clearly define standards of performance at the collector level and institute procedures to monitor collectors' adherence to such standards. Performance standards would include such things as nature and frequency of debtor contacts, time frames for resolving accounts, and use of legal action and other methods to collect amounts outstanding (paragraph 29.85).	○
The Department should assess the feasibility of using standard codes as a means of identifying and aggregating collection action taken by collectors in a timely, summarized manner and capturing results associated with those actions (paragraph 29.91).	○
Actual dollars collected and dollars written off should be tracked separately for individual collectors and teams and taken into account when assessing collectors' performance (paragraph 29.91)	●
The Department should monitor time spent by collectors in both cash-generating and non-cash-generating activities (paragraph 29.91).	○
The Department should conduct an annual review of all of its accounts and write off amounts that are deemed uncollectible. In estimating the realizable portion of tax debts remaining in inventory, the Department should consider the age of unpaid assessments, as well as remissions and other adjustments that can reduce the balance of reported amounts outstanding (paragraph 29.106).	●

● **Satisfactory**—Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

○ **Unsatisfactory**—Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

8.72 For example, the Agency is working on the Integrated Revenue Collections (IRC) project. The project was initiated in 2001, and by March 2005 the Agency had spent $13 million on it. However, no comprehensive business case was prepared and certain fundamentals of project management were missed. Since September 2005, the Branch has taken important steps to control the project, including establishing a project management office and preparing detailed planning documents. By March 2006, the Agency will have spent about $30 million, almost 40 percent of the estimated total cost of the project. It has received some deliverables, such as the first release of All Revenue Tables, and has many others in progress. We note that some parts of the project were falling behind the schedule that was developed in January 2005. The Agency will need to be diligent in the months ahead if the project is to be delivered on time, on budget, and with the expected deliverables.

Conclusion

8.73 While the Agency has made improvements in the collection of tax debts since our 1994 audit, the tax debt continues to grow at a faster rate than total taxes paid, and aging accounts are a problem. We found that the Agency's approach to assessing tax debts for risk continues to have major weaknesses that impede their timely and efficient collection. We also found that the Agency has taken some steps to handle tax debts efficiently, but much more needs to be done. Management lacks the information it needs to understand the makeup of the tax debt and to develop strategies and allocate resources in a way that would significantly improve the situation. It also lacks the information it needs to determine whether it is using efficient and timely processes to collect tax debts.

8.74 The Agency has known for many years what it needs to do to improve the collection of tax debt, but it has had difficulty achieving significant breakthroughs. It now has a strategic vision that sets a course for the future. The major challenge for the Agency is to turn that vision into reality through detailed planning, focussed management attention, and measurement of results.

About the Audit

Objective

The objective of our audit was to examine whether the Canada Revenue Agency uses efficient and timely processes to collect tax debts.

Scope and approach

We examined the collection of tax debts in four of the Agency's revenue lines—personal tax, corporate tax, goods and services tax, and payroll source deductions—that together constitute about 86 percent of all tax debts. We interviewed staff, reviewed files and management reports, and analyzed data.

From the four revenue lines in our audit scope, we selected for audit a sample of 151 tax debts that were active at 31 March 2005. The sample included

- 72 personal tax debts,
- 32 corporate tax debts,
- 26 goods and services tax debts, and
- 21 payroll deduction debts.

Within each revenue line, more high-value tax debts were audited than low-value tax debts. A total of 110 high-value tax debts were examined, accounting for about one percent of the value of the total tax debt of the revenue lines that we audited. All files were selected in a random and unbiased fashion from the tax debts of the four Tax Services Offices that were visited during the examination phase of the audit. Tax Services Offices have policies and guidelines that require the handling of tax debts in a uniform manner. All sample items were given an equal weight when results were calculated.

We also considered whether the Agency has made satisfactory progress on the issues that we reported in 1994 and that Revenue Canada also reflected in its 1995 action plan to the House of Commons Standing Committee on Public Accounts.

We examined good practices in the collections operations of ten organizations. They included two federal revenue agencies, two Canadian provincial revenue ministries, four United States state revenue agencies, and two private sector financial service firms.

In addition to discussions with the Agency at its national headquarters in Ottawa, we visited Tax Services Offices in Vancouver, Calgary, Winnipeg, Toronto Centre and Toronto North, Ottawa, Montreal, and Halifax. We visited the national pool in Toronto North and the national collections call centre in Ottawa. We also visited a credit bureau and the collection department of a large private sector company.

We did not examine debts in which the taxpayer was disputing the assessment that gave rise to the debt because, in most such cases, law prevents the Agency from taking any legal collection action. We did not examine miscellaneous tax debts, which include non-residents' taxes, other levies, excise fees, and customs fees. We did not audit the accounts that the Agency collects on behalf of Human Resources and Social

Development Canada, as this collection activity started during our audit. We did not examine goods and services tax debts in Quebec as they are collected by the Ministère de Revenue de Quebec.

We did not examine write-offs or follow up on recommendations regarding the fairness provisions, given that we had done an audit reported in April 2002, Chapter 2, Canada Customs and Revenue Agency—Tax Administration: Write-Offs and Forgiveness.

Criteria

In order to demonstrate that the Agency was efficient and had timely processes to collect tax debts, the Taxpayer Services and Debt Management Branch should

- have an overall collection strategy with clear goals and objectives;
- have specific strategies to deal with identified problems such as insolvencies;
- measure progress in meeting the goals and objectives of the strategies;
- have a good understanding of the composition of tax debts, including reasons for growth or reduction in the balance;
- base collection of tax debts on appropriate risk models;
- have appropriate procedures to resolve tax debts on a timely basis;
- have a method in place to learn about and incorporate good debt collection practices;
- have appropriate information technology systems to support the collections process; and
- provide collection officers and managers with appropriate guidance to undertake collections activities.

Audit work completed

Audit work for this chapter was substantially completed on 20 December 2005.

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Appendix List of recommendations

The following is a list of recommendations found in Chapter 8. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
The tax debt continues to grow	
8.28 The Canada Revenue Agency should identify and collect the data it needs to analyze the makeup of its tax debt and to develop better collection strategies. (8.18–8.27)	The Agency agrees that understanding the makeup of tax debt is an important factor in developing its strategies, although the Agency's efforts have resulted in increased collector productivity since 1994. In addition, the Agency has exceeded important program delivery commitments made to the Treasury Board, as noted in this chapter. The Agency has taken important steps to increase its capacity in the area of tax debt research by launching the Agency's Integrated Revenue Collections (IRC) project, which is developing advanced data-warehousing and data-mining capabilities. In addition, the Agency has set up a team within its organization dedicated to conducting debt management research. These initiatives will support the horizontal approach to compliance research across the Agency. The Agency is taking important steps to ensure that the IRC project is being managed in accordance with accepted project management practices. Some deliverables have already been released, such as the All Revenue Tables.
Management lacks important information on performance	
8.41 The Canada Revenue Agency should significantly improve its management information to make it complete and comprehensive. It should develop reliable techniques and information sources to determine on a regular basis the results of its collection efforts and use that information to guide its decision making for each of its major collection modes and actions. (8.29–8.40)	The Agency agrees that improvements are needed to enhance its management information systems—improvements that are currently being addressed through its Integrated Revenue Collections project. However, the Agency believes that the performance indicators it has established for its collections program appropriately reflect program activities, including write-offs. The Agency continues to review its performance indicators in order to ensure their accuracy and appropriateness. This review is in line with the OAG's annual performance assessment on the fairness and reliability of the program information described in the Agency's Annual Report to Parliament.

Recommendation	Department's response
	The Agency continues to manage uncollectible accounts in accordance with the procedures that were favourably reviewed by the Auditor General in 2002.
Risk management is deficient	
8.52 The Canada Revenue Agency should establish a more comprehensive automated risk-scoring system for tax debts, update the risk scores on an ongoing basis, and use the risk scores to prioritize workload throughout the collections process. (8.42–8.51)	The Agency agrees. Additional investments in risk management systems are needed, and are being made, to realize the full potential of the Agency's collections program and to address the continued growth in accounts receivable. The Agency's Integrated Revenue Collections project is focussed on addressing both past and current concerns raised by the Auditor General with respect to risk assessment and file management, in addition to the above-mentioned management information system improvements.
Efficiency improvements needed	
8.65 The Canada Revenue Agency should minimize the number of collectors who work on each account, record their collection actions in a more systematic way, and improve the case management tools they have at their disposal. (8.53–8.64)	The Agency agrees. The Agency will undertake an initiative to identify file management inefficiencies and improve the effectiveness of collector actions on case inventories. The Agency will build on process improvements it has made, such as the national collections call centre and national pools, to further improve its file management. More specifically, the Integrated Revenue Collections project will improve the case management tools available to perform all Agency collection activities.

MAY 2006

A Message from the Auditor General of Canada

Chapter 1 Managing Government: Financial Information

Chapter 2 National Defence—Military Recruiting and Retention

Chapter 3 National Defence—NATO Flying Training in Canada

Chapter 4 Canadian Firearms Program

Chapter 5 Management of Programs for First Nations

Chapter 6 Management of Voted Grants and Contributions

Chapter 7 Acquisition of Leased Office Space

Chapter 8 Canada Revenue Agency—Collection of Tax Debts

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